Beyond The Global Financial Crisis: Challenges Facing Venture Capitalists Operating In An Emerging Economy such as Nigeria

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Abstract

Objectives: The study investigates the challenges faced by venture capitalists (VCs) when operating in an emerging market, as well as problems in dealing with the entrepreneurs themselves. This is to gain a deeper understanding of the environmental and governmental policy factors that are hindering the growth of the industry in Nigeria.

Prior Work: In light of the recent global financial downturn where people are being made redundant, many could see it as an opportunity to start up their own business. However, the smooth operation of the finance escalator has proved difficult to achieve under recent financial conditions (North et al. 2013; Gill 2010; Mason et al 2010; NESTA 2009. Moreover, in an emerging economy, small business owners are more likely to secure funding for their new business venture from traditional sources rather than venture capital (VC) since they do not know much about it (Gupta and Sapienza, 2001). Jiang et al. (2014) argue that although the role of VCs is well documented in western developed economies, limited attention has been paid to it by SMEs in emerging markets.

Approach: The data was collected using qualitative method involving interviews with 4 VCs who operate in Nigeria, 5 entrepreneurs who were not able to secure venture capital (VC) funding for their ventures and a government minister and a member of staff as key informants.

Results: The results show that VCs who operate in Nigeria face challenges which are unique to an emerging economy. The findings suggest that people do not fully understand what VCs look for in a business, the benefits they bring to a business, how they work and the time it takes to get things done from a bureaucratic and legal perspective.

Implications: The implication of the study is that the Nigerian government should take steps to improve the country's VC industry by setting up of a VC fund for technology-based starts-ups. The government should also meet with the heads of the major financial houses in Nigeria in an effort to create a positive public relation campaign to highlight the benefits VCs bring to businesses. This will help significantly towards the development of the industry in Nigeria.

Value: This study makes contribution to the growing body of literature on venture capital and the effect of global financial crisis. A better understanding of the decision making process of deal structuring will help VCs to make better decisions regarding investments and stages of funding. Understanding how VCs decide when and where to invest, might benefit entrepreneurs and SMEs with respect to attracting VC as well as increasing the likelihood of receiving higher levels of funding, because a higher level of financing gives them a bigger level of flexibility (Payne et al. (2009).

Key words: venture capital, emerging economy, global financial crisis.

Introduction

Small and medium-sized enterprises (SMEs) account for 87 percent of the enterprises in Nigeria and contribute 70 percent of the country's employment (Okwu et al. 2013). However, SMEs in Nigeria have limited collateral and thus find it difficult to gain finance from banks, which are the main financing channels for small businesses, given the developing nature of the financial markets, which is nothing to compare with the size and scale of the financial market in the developed world. The total funds under management in Nigeria are approximately $75 million, with about 43% of it from US and European government and aid agencies, 17% from local banks, 25% from local pension funds, and 15% from founders, friends and families (Okwu et al. 2013).

In light of the recent global financial downturn where people are being made redundant, many could see it as an opportunity to start up their own business. However, the smooth operation of the finance escalator has proved difficult to achieve under recent financial conditions (North et al. 2013; Gill 2010; Mason et al 2010; NESTA 2009. Moreover, in an emerging economy, small business owners are more likely to secure funding for their new business venture from traditional sources rather than venture capital (VC) since they do not know much about it (Gupta and Sapienza, 2001). Jiang et al. (2014) argue that although the role of VCs is well documented in western developed economies, limited attention has been paid to it by SMEs in emerging markets.

Analysts, business leaders and politicians have pointed out that an important factor responsible for the economic growth of the United States of America was VC funding (Samila and Sorenson, 2011). Therefore, one could argue that it would be in the interests of a government of an emerging economy to encourage outside investments as a means of stimulating their economy.

Setting and operating a business in a developing economy will present challenges particularly to foreign VCs. According to Meyer et al. (2008), foreign market entry strategies include paying particular attention to its resources, capabilities and its need to minimize transaction costs, while Wright et al (2005) argue that the "rules of the game" in the host economy significantly shape the entry strategies of the firm entering the developing market. Traditional transaction cost research tends to focus on micro-analytical aspects such as bounded rationality and opportunism (Meyer et al. 2008). As a result of this focus, questions of how macro-level institutions influence transaction costs have been largely unexplored.

With regards to the deal structuring of VCs decision-making process, Payne et al. (2009) suggest that having a better grasp of the decision making process will help VCs to make better decisions regarding investments and stages of funding. Understanding how VCs decide when and where to invest, might benefit entrepreneurs and SMEs with respect to attracting VC as well as increasing the likelihood of receiving higher levels of funding, because a higher level of financing gives them a bigger level of flexibility (Payne et al. (2009).

The main aim of the study is to investigate the challenges facing VCs operating in an emerging economy such as Nigeria. Specifically, the study will investigate the following:

- The attitude of Nigerian-based entrepreneurs in attracting VC funding;
- What VCs look for when deciding on a venture in which to invest;
- The impact of the global financial crisis in relation to VC investment in Nigeria.

The structure of the article is as follows. It commences with a review of the literature, exploring the central tenets of VC funding, which sets the theoretical framework. The next section describes the methodology adopted for the study, followed by the analysis and discussion of the findings, from which the conclusions are drawn. Finally, implications are provided, based on the research results.

The theoretical Framework

This section provides a critical review of the literature on venture capital (VC) and venture capitalists (VCs) specifically in the context of the qualities they look for before investment in a business venture in an emerging economy such as Nigeria in the wake of the global financial crisis. The study will also analyse the literature concerning VC activity in Nigeria as well as reviewing the literature concerning the selection criteria used by SMEs regarding the selection of sources of finance for their venture.

A Brief History of VC in Nigeria

A Nigerian government policy known as the Structural Adjustment Programme (SAP) was introduced in 1986 as a result of the failure of previous governments' financial policies to achieve a desirable economic growth against the backdrop of a failing economy (Agundu & Dagogo 2009). The introduction of SAP and the economic conditions at the time (import restrictions, rationalisation of government expenditure and financial liberalisation) resulted in the growth of SMEs in Nigeria. SAP was stopped because it lacked sustainability and was incapacitated by public sector bureaucracy. As a result of this, the finance window meant to provide assistance to SMEs became history. There was a perceived retrogression in the area due to inappropriate financing strategy which resulted in low profitability (Ollor & Dagogo 2009).

In order to remedy these perceived problems, a program known as the Small and Medium Enterprises Equity Investment Scheme (SMEEIS) was introduced as a more sustainable equity based financial strategy. In contrast, Abereijo & Fayomi (2007) feel that it was the Central Bank of Nigeria (CBN), in response to the problem faced by SMEs regarding the lack of access to capital, which introduced a method of financing for SMEs through equity financing i.e. Venture Capital. This was done after finding out that debt financing did not do enough to bear the risks associated with SME start-ups.

The scheme required all commercial banks to save 10% of their profit before tax for equity investment and the promotion of SMEs that met guidelines stipulated by the bankers committee. The aim of the funding was to reduce the burden of interest and other financial charges expected under normal bank lending. On the other hand, Abereijo & Fayomi (2007) argue that SMEs need more than just capital in the economically depressed market of Nigeria. They suggest that SMEs need highly focused and on-going assistance in a number of areas such as financial controls and marketing. Both Ollor & Dagogo (2009) and Abereijo & Fayomi (2007) agree that previous policies put in place to aid the growth of the SME sector were not adequate and resulted in the birth of VC in Nigeria.

Finance gaps and the finance escalator

The finance market for SMEs is imperfect (Modigliani and Miller, 1958) and information asymmetry is considered to be the main cause of market failure and finance gaps (Akerlof 1970; Myers and Majluf 1984; Lean and Tucker 2000). This is due to the lack of, or insufficient, information between the finance provider and the business owner, which means that entrepreneurs know about themselves and their businesses than it is possible for the lending organisations to have of them. This problem becomes more serious for young innovative businesses which do not have track records to demonstrate their market traction and value, and often lacking sufficient collateral. These businesses require risk equity finance, but face problems of adverse selection and moral hazard (Carpenter and Peterson 2002), which result from the prohibitively high cost of due diligence for relatively small–scale seed and early stage investments and reflected in the resultant poor performance of these equity markets in recent years (Mason et al. 2010; BVCA 2013).

Adverse selection arises when a venture capitalist is unable to verify what the entrepreneur knows before signing a contract and the quality of the investment opportunity (Lahti 2014). This results in either the investor providing finance for a business that subsequently fails or refusing to provide finance for a business that would have been successful (Deakins and Freel 2009). Therefore, VCs invest heavily in mitigating the risk of adverse selection (Arthurs and Busenitz 2003).

Moral hazard occurs when it is impossible to observe entrepreneur behaviour in the venture, so they may act opportunistically by not putting forth the agreed effort required to run the business operation successfully (Lahti 2014). This implies that business owners are using the company's resources for their own benefit. In other words, moral Hazard is the difficulty of the funder to monitor the activities of an entrepreneur once the finance is raised as there is no guarantee that the entrepreneur will act in the best interest of the funder (Deakins and Freel 2009).

A conceptual framework of declining information opacity of young firms as they progress through early stage financing has been presented by Berger and Udell (1998). This underpins the finance escalator model (NESTA 2009), which suggests that different forms of finance, including grant, equity and debt, are suited to young businesses as they become more established, gain market traction and are better understood by financers. This stages model will vary according to national and local circumstances relating to the supply of different types of funding over time and also on the nature of the young viable business. For example, new start-up businesses including corporate spin outs with well-established trading track records could access bank finance from start-up (North et al. 2013).

Abereijo and Fayomi (2007) and Ollor and Dagogo (2009) present a clear picture that the finance escalator in Nigeria is sub-optimal. If the impact of the GFC and the resultant squeeze on finance through bank credit rationing (Cowling et al. 2012) and a more cautious approach by investors (North et al. 2013) resulting in blockages at the seed and early stage investment markets are factored in, it is clear to see how an already under pressure early stage finance escalator is broken and fragmented (Mason et al. 2010; Gill 2010; North et al. 2013). Therefore, it seems there is a strong justification for public policy intervention in order to address these funding gaps in Nigeria.

Table 1:

<u>A comparison of the finance escalator between the developed and emerging economies</u>

Developed economy (UK/US)	**Emerging economy (Nigeria)**
Initial Idea/Feasibility: Own cash; 3 Fs; Earned income	Initial idea/Feasibility/Prototyping: Own cash; 3Fs; Bank Loan; Earned income
Feasibility/Prototyping: Grants (Govt, EU, TSB, RDA);	

Business angel; Earned income	
Commercialisation: Bank Loan; Venture capital; Sales	Commercialisation: Bank loan; Venture capital (infancy); Sales; Earned income

How do entrepreneurs decide on sources of funding?

New businesses often have difficulty in accessing finance (Jones & Jayawarna 2010; Gupta & Sapienza 2001; Perez, 1986). In their efforts to compete with existing businesses, SMEs face major challenges regarding to size and age (Witt 2004). In the Pecking Order Hypothesis, Myers (1984) argues that firms fund their financial needs in the following order: internal sources of funds, debt and then finally external equity. However Myers (1984) does not indicate the type of economy to which his theory will be applicable or indeed the size of the firm or the type of industry in which the firm operates. On the other hand, Seifert & Gonenc (2010) argue that the pecking order of finance is not stringently followed when the firm in question has an abundance of future investment opportunities. Furthermore, they suggest that raising external equity prior to exhausting all debt opportunities could make it easier to fund future investment projects.

By testing the Pecking Order Hypothesis in 23 emerging markets, Seifert & Gonenc (2010) found support for Myers' theory in emerging markets that suffered from either information asymmetry issues and or agency costs. However, they conclude that their findings are consistent with the notion that the environment in which the firm operates influences the financial decision of the firm.

In contrast, Abereijo & Fayomi (2007), feel that the rationale behind SMEs decisions on sources of finance may be different from those of larger enterprises even if the pattern supports the pecking order of finance. They argue that a strong desire of the SME owner for control makes the preference for internal finance and the aversion to external equity finance much stronger than for larger companies. They argue that as a result of this there are constrains when applying the pecking order theory to SMEs.

However, when using panel data methodology to test the hypothesis on a sample of 3000 SMEs in Spain covering a period between 1995 and 2004, López-Gracia & Sogorb-Mira (2008) observe that despite SMEs following the pecking order model, greater trust is placed in SMEs that aim to reach optimum leverage. Their results suggest that internal resources, opportunities for growth, non-debt tax shields, age and size appear to play a pivotal part in determining the SME capital structure. A possible explanation for the differing results between López-Gracia & Sogorb-Mira (2008) and Abereijo & Fayomi (2007) could be that López-Gracia & Sogorb-Mira (2008) studied SMEs in a developed economy (Spain) whilst Abereijo & Fayomi's study focused on a developing economy (Nigeria). Moreover, Abereijo & Fayomi's study focused on manufacturing SMEs, whilst López-Gracia & Sogorb-Mira (2008) looked at SMEs in general.

Benefits of VC funding to entrepreneurs/SMEs

The major benefit of VC funding is in the form of foreign direct investments (FDIs). Foreign direct investments (FDIs) can be described as flows of capital, technology and know-how from one country to another (Driga 2011). FDIs are essential funding alternatives for investment and a valuable tool for the firm receiving it as well as for the economic development of the host country.

Therefore, VCs add value to a firm by bringing entrepreneurs and investors together in an efficient way, which leads to better investment decisions (Pintado et al. 2007; Gupta & Spienza, 2001). Similarly, Zacharakis & Meyer (2000) suggest that ventures backed by VC funding tend to have higher rates of survival when compared with ventures that did not have VC backing.

Another benefit of VC funding is through absorptive capacity. Absorptive capacity is defined as a firm's ability to be innovative by identifying, assimilating and making use of knowledge available in its environment (Flatten et al., 2011; Lane et al 2006; Cohen & Levinthal 1989). Therefore, in order to produce and to be able to commercialise innovation successfully, firms must amalgamate a vast variety of expertise and knowledge produced by different complementary external sources (Muscio 2007). Based on the above, it is clear that whilst VCs will provide financing and expertise to the firm or venture that they invest in, a lot will depend on the ability of the firm to understand and apply the knowledge it has received. Muscio (2007) concedes that only a handful of scholars have studied absorptive capacity in the context of SMEs and newly established firms. Absorptive capacity is considered pivotal in firms' international processes as perceived market uncertainties such as knowledge gaps in relation to business environments in foreign markets may curb firms' tendency to commit resources to these markets (Petersen et al. 2008).

Venture Capitalists in emerging markets

There is a major change of focus from the traditional attitudes of VCs investing in their home country towards investing in emerging markets (Groh et al. 2011). This supports previous work by Ahlstrom & Bruton (2006), Bruton et al. (2004), and Lockett & Wright (2002), who suggest that emerging markets attract investors because they have exceptional growth opportunities but also require considerable funding. In coming up with their index, Groh et al. (2011) used six key drivers to calculate each countries index: economic activity, depth of the capital market, taxation, investor protection and corporate governance, human and social environment and entrepreneurial culture.

Groh et al. (2011) did not focus only on emerging economies but on all economies so that their index can be used as a guide worldwide. However, their index does not come to the same conclusions as Schertler & Tykvova (2011), which takes into account the domestic market conditions and the international experience of the venture capitalist. It should be noted that Schertler & Tykvova (2011) used quantitative data in coming up with their conclusions, while Groh et al. (2011) used qualitative data, which could explain the differences in their conclusions. It could be argued that Schertler & Tykvova (2011) are based on fact while Groh et al. (2011) is based on opinion. Similarly, Ahlstrom & Bruton (2006) and Peng (2001) argue that the trend of investing in an emerging market presents a challenge because emerging markets tend to undergo significant economic transition as well as offering little protection for investors.

Market conditions make it difficult for VCs to select the firms to fund and to monitor their investments effectively (Ahlstrom and Bruton 2006). The view that VCs are willing to invest abroad is refuted by Gilson and Black (1998) who suggest that VCs look for surroundings with well-organized markets for corporate control and capital as well as systems with minimum corruption, which readily allow for an exit from their venture. Wright & Ken (1998) also suggest that information asymmetry problems between VCs and the entrepreneur may vary between countries, causing implications on the behaviour of VCs.

Gompers and Lerner (1999) are also of the opinion that VCs invest locally as opposed international due to institutional instability. However, Ahlstrom and Bruton (2006) point out that emerging economies are rarely institutionally stable. Examples of such economies include China and Russia, which are known for being volatile, unpredictable and for having an uncodified institutional environment but have seen foreign VC investment (Peng, 2001).

In a study of the behaviour of American VC firms operating in India as well as American VC firms operating in their own domestic market, Wright et al. (2002) point out that foreign VCs adapt to local market conditions as opposed to implementing their practices on the domestic market. In trying to understand the way VCs operate in an emerging market, Da Silva (2012) conducted a qualitative study of a local venture capitalist and highlighted a list of five things that need to be present in order to attract VC investment from abroad. The list includes bringing in own money, recruiting locally and seeking local partners, a handshake being worth more than a signature, sharpening training and recruiting skills, and be willing to invest in small ventures.

The findings of Da Silva et al. (2012) agree with Makela & Maula (2008) in the sense that there needs to be a local investor present before foreign VCs will invest. However, it should be pointed out that Da Silva et al. (2012) interviewed only one local venture capitalist, although having 15 years' experience and being one of the first VCs to operate in Serbia. Therefore, it seems that "a handshake being worth more than a signature" could be a cultural issue which is unique to Serbia and might not be the case in another country such as Nigeria.

Da Silva et al. (2012) were building on a study conducted by Bruton & Ahlstrom (2006), who focused on VCs in Southeast Asia, as the emerging economy. Their study also produced similar findings in the sense that the international venture capitalists wanted to mitigate the risk of investing by knowing someone who understands the venture or knows the entrepreneur before they would consider investing in the venture.

Venture Capitalists exit strategies

The study of VCs exit strategy has only started to gain speed in the last decade or so (Raghupathy & Rajan, 2010). Initial Public Offerings (IPOs) offer a potentially attractive exit route and mark an important milestone in the lives of young and growing firms (Jiang et al. 2014). However, as Jiang et al. (2014) point out, limited or no attention is paid to IPOs in emerging economies.

Although VCs feel that valuation and pricing are still important areas when making decision relating to exit strategies, appropriate timing and optimal exit route are also being studied extensively. An empirical study by Cumming & Johan (2008a) considered the role of pre-planned exit strategies at the time of signing the contract with the entrepreneur. Their study indicated firstly that pre-planned acquisition exit strategies are associated with a stronger investor control rights and veto. Secondly investors take fewer veto rights and control and use common equity in developed countries. Thirdly, experienced entrepreneurs are more likely to use common equity, while more experienced investors are more likely to use convertible preferred equity as opposed to common equity.

However, Smith (2005) indicates that the combination of exit provisions in standard VC relationship serves to lock VCs into the investment at the initial stage. In the later stage of the investor investee relationship, VCs gain increasing control of exit by securing additional seats on the board of directors as well as by obtaining contractual exit rights. Smith (2005) argues that the result of such actions was a sophisticated transfer of control from the entrepreneur to the VCs as the financial investment increases.

Cumming & Johan (2008b) provide evidence in relation to information asymmetries and agency costs to exit outcomes in VC funded entrepreneurial firms. They argue that when VCs are better able to mitigate information asymmetries and agency costs faced by the new owners of the firm, they are more likely to have a successful exit outcome. Cumming & Johan (2008b) also note that information asymmetries and agency costs will vary depending on the structure of the financing arrangement as well as the characteristics of both the firm and VCs.

In a recent study analysing the role of foreign VCs in driving venture success in emerging markets in China, Humphery-Jenner & Suchard (2013) argue that the presence of foreign VCs does not greatly increase the likelihood of a successful exit. However, a successful exit increases if the foreign VCs collaborate with a joint venture partner. Humphrey-Jenner & Suchard (2013) also suggest that foreign VCs prefer to exit via a merger and acquisition or secondary buyout as opposed to an IPO. Even in developed markets where IPO markets are available, less than 20% of VC backed companies select IPOs (Bessier and Siem 2012; NESTA 2009).

The effects of Global financial crisis on VC funding

In light of the global financial crisis and the interconnectedness of global financial markets, an increase in the global risk aversion of investors would spill over into emerging markets as investors would only seek to invest in the safest and most liquid assets in their home markets, such as fixed income securities (Frank & Hesse, 2009). As has been noted previously, VCs tend to invest in markets that they are familiar with. Therefore, it stands to reason that when conditions are volatile in the global economy, they are more likely stick to the market that they know well. In their study on the effects of the global financial crisis on VC funding, Block & Sandner (2009) argue that it was not the risk aversion or the interconnectedness of global markets that would affect VC funding, but highlight three effects.

Firstly, VC funds would encounter difficulties in finding investors due to the fact that investors in VC funds are usually large institutional investors such as insurance companies and large banks (Gompers and Lerner, 2001). This point is made more relevant as Block & Sandner (2009) highlight the collapse of Lehman Brothers and the credit difficulties experienced by AIG as part of the reason the financial crisis started and became a global issue. In light of this, they argue that banks and insurance companies were likely to decrease their investments in VC funds.

Secondly, the low activities in the IPO market and the declining stock prices have a negative effect on the exit strategy for VCs. Again, this makes sense as VCs need to have an exit strategy for their investments, as noted earlier. This is supported by Gilson and Black (1998) who argue that amounts VCs are able to raise is strongly linked to how vibrant the market is for IPOs.

Thirdly, Block and Sandner (2009) highlight the effect the financial crisis would have on consumers. They reasoned that consumers would have less money to spend and would not purchase the way they used to, resulting in difficulties for VC backed firms in receiving sufficient revenues, thus putting pressure on the firms' sales and ultimately leading to lower firm valuations.

The literature reviewed implies that there are benefits to an economy in encouraging the growth of a vibrant venture capital sector. The literature has discussed the need for venture capital amongst SMEs and entrepreneurs as a form of funding with the conclusion that VCs would bring knowledge, expertise, experience and advice as well as funding to SMEs..

The financial crisis resulted in the VCs finding it difficult to raise capital as their sources of capital tend to come from large financial institutions which were hit the hardest by the crisis due to poor investment decisions. The literature also suggested that emerging markets would suffer as a result of investors no longer wanting to invest in foreign markets. The literature is diverse in the area but there appears to be little attention given to VCs who operate in foreign countries as opposed to VCs who operate in their homes country.

Methodology

The study adopts a qualitative approach which involves semi-structured, face to face interviews. The interviews were conducted with 4 VCs who operate in Nigeria, 5 entrepreneurs who were not able to secure VC funding for their ventures, a government minister and a member of staff from the Nigerien Federal ministry of finance and economic development as key informants. In order to gain access to these people a ‘gate keeper’ was used (Stokport and Kakabadse, 1992). The ‘gate keeper’ was a relation of the second author who had set up his venture using VC funding and as a result had a number of contacts.

The aim of the interviews was to garner the personal opinions of those heavily involved in the VC funding so as to gain a better understanding of what all parties involved were looking for, and what all parties are actually able to deliver. Respondents were given a copy of the questions to be asked in the interview in order to give them time to prepare and allow for any possible objections or clarifications to be raised and addressed before the interview commenced. This approach helped put the mind of the respondents at ease by reassuring them that they were better placed to answer the questions being asked as well as affording them plenty of time to come up with their answers.

Although the interviews followed a pre-determined topic guide, respondents were encouraged to go into as much depth as possible. This led to other questions naturally being raised as more information was provided. As a result of this, each interview lasted for at least an hour and a half, while the longest interview took two and a half hours to complete. Each participant was interviewed once.

The data in this study were collected and analysed using an inductive process of recording, tabulation, coding, and constantly comparing emerging codes and categories with data until meaningful ideas emerged (Yin, 2009; Ekanem, 2007). Categories were allowed to emerge according to the topics emphasised by each participant related to their sources of funding and perception of them, especially external funding such as venture capital. The process of analysing the data began as soon as the researcher started collecting data. It was ongoing and inductive as the researcher was trying to make sense of the data collected (Shaw, 1999).

The data analysis utilised a set of techniques such as content analysis, pattern-matching, and explanation-building technique (Yin, 2009; Ekanem, 2007). Content analysis involved listening to and transcribing the tapes, reading the transcripts to list the features associated with the challenges faced by each owner-manager and venture capitalist and establishing categories which were then developed into systemic typology. These features included attitudes of owner-managers, VC selection criteria, and the effect of the global financial crisis.

Pattern-matching technique involved examining whether there were any interesting patterns and how the data related to what was expected on the basis of common sense or previous theory (Yin, 2009). It also involved examining whether there were inconsistencies or contradictions between owner-managers' and VCs' attitudes and investment behaviour.

Explanation-building technique allowed series of linkages to be made and interpreted in the light of the explanations provided by each respondent (Yin 2009; Ekanem 2007. For example, attitudes and investment behaviour by both VCs and business owners emerged from a comparison of field notes and transcriptions. The aim was to build a general explanation based on cross-case analysis.

Analysis of Findings and Discussion

The study consisted principally of 5 small firms and 4 VCs as illustrated in the profiles in Table 2 and 3 together with a summary of the findings. Extracts from the interviews with the firms' owners and VCs are presented in this section.

Table 2: VC Company Profile

Company	Year business started	Focus/Sectors	Challenges
VC1	2004	SME and Entrepreneurial start-ups	Effective management; Due diligence; Effect of financial crisis is significant; had fingers burnt; Having companies within same geographical location; Profitability of venture to ensure smooth exit;
VC2	2006	Sub-Saharan Africa, Technology-based businesses, includes telecoms, internet, payments, financial services (industry agnostic with some restrictions like gambling, tobacco etc.)	No. of portfolio companies; Cost of due diligence ; Contribution of management team; Proximity is an issue; Exiting investment is also an issue; No funding at all during the financial crisis;
VC3	2005	SMEs that operate within selected sectors of the Nigerian economy namely; Power, Oil and Gas, Financial Services technology, and Fast Moving Consumer Goods (FMCG)	Quality of management team; Value added; Due diligence; Distance between portfolio companies; Exit strategy; Investment severely restricted during the crisis; Lack of understanding of own business by entrepreneurs

VC4	2004	Emerging markets in Africa and Asia and Latin America with business and start up that operate in select industries in namely; Energy, Consumer Goods, Real Estate, Financial Services, Health Care and Industrials.	Ability to have face-to-face meetings with companies without the travel costs; Efficient management team; No. of companies invested in; Cost involved conducting due diligence; Financial crisis increases risk of aversion; Realising a return on the investment.

Table 3: SMEs Company Profile

Company	**Years in operation**	**Sector**	**No. of Employees**	**Turnover**	**Challenges**
S1	4	Architectural services - Commercial, residential, civic and interiors. No construction. Just design	6	N300m	No sufficient funding; Poor credit history; Loss of control; VCs are “too hands-on”
S2	6	Information Technology Sector (Software Development)	45	N150m	Not qualified for VC funding; Loss of control; High rates of interest;
S3	3	Creative consultancy	4	N200m	Terms of funding; Loss of control; Use of trade credit;
S4	4	Oil and Gas	40	N500m	Lack of adequate or sufficient funding; Lack of access to funds at favourable rates; Poor credit history;
S5	20	Fashion	5	N80m	High rate of interest; Perceived lack of need for finance; Discouraged borrower effect;

					Lack of credit history; Borrow from parents; Lack of personal introduction; It's about who you know; Do not meet VC criteria

Attitude of Nigerian-based entrepreneurs in attracting funding from investors

In analysing the attitude of Nigerian small business owners towards external funding, a number of factors were established which included lack of adequate and sufficient credit, terms of funding, lack of personal introduction and lack of understanding of business valuation.

Lack of adequate/sufficient credit

One of the main challenges to emerge from the interviews with the SME owners and the VCs was that there was a lack of adequate/sufficient credit available from VCs and other lenders. Therefore, entrepreneurs tend to ask family and friends for short term loans. They did not know how to go about seeking funding from VC firms or think that a VC firm would be interested in funding their venture in the first place. The owner of a fashion business stressed:

> *"What's the point of going to VCs? Even banks, their rates are far too high, I doubt they would lend me the money anyway I haven't got a credit history with them. It's much easier to ask my parents for the money…Obviously I'm going to pay them back, but it won't be double what I borrowed, and if things get tight for me, my parents aren't going to threaten to take my belongings or worse!"* (S5)

It is important to note that the types of businesses referred to in the quote above are small businesses which employ less than five members of staff as opposed to those which employ ten and above. One possible reason for this is the fact that the smaller businesses in Nigeria tend to be family owned and supported businesses, which exist as a means of supplementing the household income, and as such are not likely to generate substantial earnings or returns of investment. These types of business are more likely to ask family or friends for a loan which will be paid back under terms and conditions agreed by those involved. They see this type of loan to be more appropriate to their needs as it is less formal with little or no paper work involved. It is also less risky from the entrepreneur's point of view and comes with fewer conditions on what they need to do to receive the money. Raising loans from these sources allows them to borrow from people who they trust and who trust them and in some cases they do not have to pay the person back.

It is obvious that businesses which employ less than 5 people and are not innovative in any way are not the type of businesses that VCs would be interested in as there is no likelihood of them ever generating or having the potential to generate large incomes. The problem with the finance required by these types of businesses or early stage risk finance is that the amount is often too small and risky to make it worthwhile for equity investors such as private VCs as the cost of due diligent is too high (North et al., 2013).

Also, the industry and products/services these types of business are involved in are not particularly innovative or unique. The respondent VCs indicated that they prefer to invest in *“technology enabled business, e-commerce businesses, businesses offering financial services and fast moving and innovative businesses.”* However, it is important to note that innovations are appealing to VCs only when they can be successfully commercialised (Lahti, 2014) and quickly rather than over longer investment horizons (NESTA 2012; Rowlands 2009).

Terms of funding

Those businesses which employed 30 or more people agreed that they would like to have access to more funds to allow them to expand their operation and cover short term cash problems but did not have access to favourable loan rates from traditional lenders due to poor credit history not to mention VCs. The owner of a creative consultancy emphasised:

> *“Of course I want access to more money, who doesn’t? The problem is the terms that come attached to the money you’re talking about. I run the risk of losing the business to the banks or investors if for one reason or another I can’t afford to repay the ridiculous interest that the bank charges, it’s just not worth the risk for a short term cash problem. It makes more sense to come to an arrangement with the supplier who we owe or to chase those who owe us money* (S3)

This quote demonstrates the loss of control as one of the typical reasons why small business owners do not want to use external funding. The use of VC by small businesses is often resisted on account of losing control to the VCs who always insist on making sure the company is run efficiently (Lahti, 2014).

Lack of personal introduction

Another reason the respondents in the study would not seek external funding including VC is the lack of people to introduce them to these sources of funding. They felt that they were refused credit due to the fact that the bank manager did not like them on a personal level and as such even if they had good credit they would not have got the loan in the first place. This particular view was also shared by those who employed 5 people or less. It was suggested by the respondent that unless they knew someone who worked in the bank either directly or through a third party, then there was no way they would be eligible for a loan:

> *“In Nigeria it’s all about who you know… if I had gone to school with the bank manager or our parents were friends, I would have got a loan with reasonable rates without having to show too much documentation.* (S5)

Whilst that could be the case, another reason was that they simply did not meet the criteria needed to get funding from VCs or banks (especially following the aftermath of the global financial crisis) and as such they feel that it was a personal issue. However, the issue raised here by the entrepreneurs resonates with the activities of advisors or agents which are commonly used as a proxy to reduce the risk of adverse selection and moral hazard (Lahti 2014).

Lack of understanding of business valuation

In the interviews conducted with the VCs, it was felt that entrepreneurs can be difficult to deal with. When asked about doing deals with entrepreneurs, one respondent said:

> *“They may understand their own business but not industry as a whole”* (VC3)

This means that VCs consider some business owners to lack the ability to understand the industry in which their business operates. Another venture capitalist interviewed complained about small business owners not understanding how a business is valued. In light of this, it could be argued that when entrepreneurs hear anything negative about their business venture they take it personally and assume that they have been rejected. It could also be that the investor clearly cannot see the potential in their business idea. Payne et al. (2009) suggest that from VCs' perspective, a better understanding of these decision-making processes can enable more prudent decisions regarding investments and stages of funding. Small business owners would also prefer to be on friendly terms with the investor so that they would bend the rules and not been so stringent when conducting their due diligence. Due diligence is of course what would be expected of a responsible investor, especially in the aftermath of the GFC (North et al. 2013.

VC selection criteria

During the interviews the recurring themes with regards to VCs investment selection criteria focuses on the attractiveness of the venture, the possible future returns or prospects of the venture (also known as Ex-Ante). Other recurring themes included their appetite for risk, the market size, customer adoption and competition. The management team behind the venture, how they can monitor their investment, and the terms of the deal were also mentioned as being important for VCs. These factors allow them to complete their due diligence and ultimately decide if the venture is worth investing in. In effect, the VCs were emphasising that the business proposition must be right and marketable. It must also be sizable in home market and exportable as the amount of 'hands on' time will be really crucial with regards to seed/early stage finance.

Management team

With regard to investing in a venture opportunity which is situated in an emerging market in addition to the criteria mentioned above (which are scrutinized in more depth than ventures in a developed country), particular attention was paid to the management team behind the company. One of the VCs interviewed emphasised:

> "*We also pay close attention to the quality of the management team in place, how much value do they add and what can they contribute"* (VC3).

The main reason why VCs pay particular attention to the management team is to help reduce the problem of moral hazard. Since previous studies (Wright et al., 1997) suggest that VCs tend to have confidence in entrepreneurs with an extensive track record and experience, a strong management team may provide a credible signal of high ability that improves an entrepreneur's chances of obtaining funding. It could also be argued that in the absence of local investors, the foreign VCs would pay greater scrutiny to the management team, who amongst other things will be able to provide the local knowledge required by the foreign VCs, thus reducing the risk of moral hazard and adverse selection. Payne et al. (2009) argue that if VCs feel confident in the entrepreneurial team, then higher levels of funding will be offered to the entrepreneurs initially and totally, all else being held equal. However, it should be mentioned that this support service can also be delivered through syndicated local co-investors (Abell and Nisar (2007).

Proximity

The ability or ease with which the VCs are able to travel to the location of the company or venture also played a significant part in the selection criteria of the VCs when considering investing in an opportunity in a developing country. One way foreign VCs were able to ensure local knowledge was to have a representative based in the city (or within a commutable distance) of where the company in which they are investing is based. This allows for a “hands on” approach when it comes to providing the management team with assistance, advice or resolving any issues. The ease with which they are able to travel to the location of the portfolio company is significant for the VC firm. It also helps to reduce their monitoring cost. This was demonstrated in the following quote:

> *“Sometimes the best way to get your point across or address an issue is to have a face to face meeting, but you don’t want to spend half your whole day getting there, having a 2 hour meeting, and then the other half of your day getting back. That’s time that could have been spent being more productive”* (VC4)

This finding supports the finding in Lutz, Bender, Achleitner and Kaserer (2013). The study examined the importance of spatial proximity between investors and investees. The results suggest that even in economies with a dense infrastructure such as Germany spatial proximity between investor and investee impacts the likelihood of an investment. However, as discussed earlier, sector syndication with local investment partners can overcome this problem (Abell and Nisar 2007).

Optimum portfolio

Another point considered by respondent VCs was the number of portfolio companies in the emerging market. In the interview, it was pointed out that VCs would quite often invest in a number of start-ups and would try to ensure that they all operate not only in the same geographical location, but in the same building as is the case with seed funding. This allows them to “kill two birds with one stone” without wasting time and money trying to get from one place to the other. A participant venture capitalist responded:

> *“Advising firms is time consuming. So, there must be a trade-off between intensity of advice and the number of companies in which we invest. We have to determine the optimal number of portfolio companies as a small number would not be cost effective.”*

The above quote demonstrates the significance of determining the optimal number of portfolio companies in which VCs should invest (Markovitz 1952). Kanniainen and Kenschnigg (2003) advise that diminishing returns to advice per firm call for a larger portfolio. However, they also warn that with progressively increasing managerial cost, an excessively larger number would crowd out advice to each individual firm.

Exit strategy

The question of how VCs exit their investment was also raised as that would surely form an important part of the selection criteria. The venture capitalist interviewed remarked:

> *“Listen, in this climate, if the venture is profitable enough there will always be people who will want to take it off your hands and make money. However, this is a very important point of consideration and we worry about it a lot.”* (VC1)

Although VCs generally take concentrated ownership stakes in financed firms and have a substantial influence on management, they have to exit portfolio firms to realise a return on their investment (Jiang et al., 2014). Typically, IPOs offer a potential attractive exit route. The next question explored was how VCs will exit their investments in the absence of a reliable IPO market although as stated before the majority of VCs in developed markets do not select IPOs (Bessier and Siem 2012).

All the VCs interviewed alluded to the fact that there would always be a bidder. If it is not the actual owner of the firm wanting to buy out the VCs, then a larger VC firm both locally and abroad would inevitably be interested in taking it of their hands. Jiang et al. (2014) argue that although the role of VCs in IPO is well rehearsed in developed markets, limited attention has been paid to the role of VCs in IPOs by SMEs in emerging markets. This is probably because what is more interesting is how VCs prepare to sell their investment via trade sales, syndicate or to larger later stage VCs.

Effects of the global financial crisis
This topic raised many interesting answers and opinions as to the effect the global financial crisis (GFC) had on the VC and PE industry in Nigeria. The two major challenges for investors operating in Nigeria, which were highlighted by all the VCs interviewed, were fund raising and investing.

The GFC of 2008 largely affected the fund raising efforts of VCs. One of the problems was that foreign investors did not want to invest in a business outside of their home country. Their risk aversion was greatly increased, resulting in them wanting to invest in ventures they were familiar with. One respondent reflected:

> *"We felt that our fingers had been burnt when the crisis hit and didn't want to expose ourselves to anything risky. As such, we decided it was best to invest in property in London and Dubai"* (VC1)

Having their "fingers burned" suggests the severity of the GFC. According to those interviewed, another consequence of the GFC in relation to fund raising for VCs was that investors wanted a guaranteed return on their investment:

> *"The risk aversion of investors increased considerably following the crisis…Every investor started to think only of guaranteed return. Not only VCs, banks have also trained their staff to only think of guaranteed returns"* (V4)

This has posed a major problem as VCs tend to invest in businesses that are traditionally seen as risky but whose potential financial benefits mitigate the risk associated with ventures. In light of the financial crisis and the size of the institutions it affected, one can understand investors' reluctance to invest in anything they felt was risky. As a result, the desire to invest in property in the belief that prices will recover at some point is also understandable. Assessing the impact of the financial crisis on young and established technology-based small firms, North et al. (2014) conclude that both debt and equity finance have become harder to access, particularly for early stage funding and for more R&D intensive firms, hampering their growth potential.

The question was asked about the possibility of raising capital locally and if it would be easier as investors would be more familiar with the business environment and have an idea of what businesses would be most likely to survive in the Nigerian market. The response was that "high net worth individuals" [VCs] were looking to invest their money abroad instead of investing locally, while foreign investors did not want to invest outside of their countries, especially in a developing market. It seems that investors prefer to more secure markets and later stage investments – retrenchment to blue chip stock approach (Mason et al. 2010).

Ironically, investors within the developing country were not willing to invest in their home country despite their local knowledge. Again, the need for a guaranteed return was cited as a major reason for this. The local investors held the view that their local developing economy was more risky than one that had suffered a significant crash and was in need of serious support from the governments of the developed countries. A possible reason for this is the fact there would be greater legal recourse and guarantees available to those that invested in a developed economy. Secondly, while little is reported about any effort made by the governments of the developing countries to help their own economy, the efforts of the governments in the developed country to help their economy are widely known and reported

The problem of investors wanting “guaranteed returns” was also mentioned. When it was put to the VCs that guaranteed returns would be difficult (if not impossible) promise to make, the response given was that many investors has trained their staff to deal primarily in investments that provide the most secure chances of returns (Mason et al. 2010).

Conclusions

The evidence presented in this paper demonstrates that the main businesses that Nigerian-based VCs will invest in are mainly technology-based business, fast moving consumer goods (FMCG) and innovative start-ups. However, for international VCs looking to invest in a venture in Nigeria, the ability to monitor and influence their investment is important. They focus on the potential to grow and generate sustainable revenues and thus value the business accordingly. Therefore, VCs are concerned with revenues and the sector in which it is operating. The more stable the sector the better it is for investors in view of the GFC. VCs also placed high importance on market share relative to the competition and the managerial structure in place.

The evidence suggest that a strong technical management team with solid commercial and operational judgement in place would be more attractive to VCs and more likely to gain funding than a business without a strong management team. As VCs need to monitor their investments closely as well as provide support to the investee firm, having a strong management team in place which is able to make reasonable business and operational decisions is beneficial and make the process easier (Wright et al 1997; Payne et al 2009). This includes the willingness to accept outside management to strengthen their position. One of the selling points of the VC model is that they will not only provide funding for the venture, but they will also take a seat on the board (Smith 2005). This allows them to monitor their investment closely and resolve issues. VCs, especially for seed funding also prefer their portfolio companies to be located within close proximity to each other, if not in the same building.

The findings also suggest that VCs pay close attention to exit routes (Jiang et al 2014). In the absence of an IPO in Nigeria, this is limited to selling to larger VC/PE firms, “high net worth individuals” or the person they were initially in partnership with such as larger companies and corporates. The main effect of the GFC on VC in Nigeria was that it became very challenging for VCs to raise funds and achieve final closing. The study also reveals a general lack of understanding of the VC process. This has resulted in long delays not only in finding the right deal, but also in closing it.

The implication of this study as alluded to by the two key informants in the study is for the government to create a positive public relations campaign highlighting the benefits that VCs can bring to a business. One way of doing this is by allowing more deals to be made public so that people can see success stories and be encouraged by the role models to set up and grow their own business through venture capital.

Another possible way of overcoming the challenges is the introduction of an agent, or organisation who could act as a middle man, or broker between the VC/PE firm and the investee firm. The literature has confirmed that firms which use VC funding are invariably more successful including serial entrepreneurs (North et al. 2013). The broker would have to be able to speak the language of both the investor and investee and could act as a guarantor for both. In the absence of an efficient legal system this could act as a form of arbitration agreed by both parties prior to concluding the deal.

The government should consider creating a business school which can cater for the needs of entrepreneurs to ensure that they understand the basics of entrepreneurship. This will help foster the entrepreneurial spirit which already exists in Nigeria, and help certain standard practices to become uniform. The government should also facilitate the successful establishment of IPO exit strategy for VCs. This should be done in conjunction with ensuring that legislation and policies introduced to foster the growth of the VC/PE industry in Nigeria are applicable to all states and not just Lagos and Abuja.

The study has several limitations which suggest the implication for further research. The major limitation of the study is the extent to which the study can be generalised to wider population of small firms. Due to the relatively small sample of respondents who took part in the study, it would not be wise to assume that their views represent that of the general population at large. It would require a larger sample for the views collected to represent the VCs operating in Nigeria. The paper makes a significant contribution to the scarce literature addressing the venture capital market in Nigeria.

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