MAIN ARTICLES

VENTURE CAPITAL AND CORPORATE GOVERNANCE IN GHANA

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Abstract

Venture capital (VC) investments in Ghana are relatively new but promise to enhance economic development. This article discusses the general description of the process and recent contribution of VC on corporate governance is discussed. This study was conducted using both complementarities framework and governed corporation principle in which venture capital firms and their portfolio firms provided the basis of resource exchanges. There is now transformation in corporate governance in Ghana as a result of VC investment. Venture capital investment at the moment is skewed in favour of late stage financing. The active participation in the portfolio firms through board representation by VC firms is enhancing corporate governance.

Introduction

Venture Capital (VC) investment has become an important part of globilisation. According to the European Venture Capital Association, (EVCA, 2005) Venture capitalists are progressively expanding their investments across their national boundaries because of the availability of abundant international entrepreneurial projects. A report presented by the European Private Equity and Venture Capital Association (EVCA, 2005) indicated that between 2004 and 2005, VC investment by Europeans increased from $12.8billion to $15.8billion. This provides some evidence that VC in Europe is growing. The Israeli Venture Capital Association (IVA, 2005) also reports that VC activities in Israel are developing rapidly. VC firms in Israel raised over $700 million in 2004 and $1.2billion in 2005, even though most of the funding come from external sources such as the United States of America and Europe in order to take advantage of entrepreneurial projects outside Europe and the USA. According to Zarutskie (2005), Venture capital provides an important financing source to start up businesses and increases the investment portfolio of many institutional and angel investors.

Venture capital is described by Gompers (1995) as "independent, professionally managed, dedicated pools of capital that focus on equity or equity-linked investments in privately held, high growth companies". VC firms mainly invest in high-technology firms where they expect that growth and returns will be higher than other industries. VC investment could also be explained as the commitment of huge high-risk equity capital into innovative projects with mutual high expected returns at exit which is aligned with specific lifespan of the projects.

The investments normally concentrate on the early stage and the growth stage firms. In America, private equity means high risk investment in the late stage ventures reflecting in leverage buyouts, privatizations, and mergers and acquisitions. In Europe, VC and private equity is the same thing. Venture Capital (VC) is normally led by the private sector in which equity capital is raised from outside the mainstream capital market (e.g. the Stock Exchange) to be distributed to entrepreneurial firms with promising and innovative projects. By this, VC firms are important part of the financial intermediation process.

VC investment is relatively new in Ghana with very few participants at the moment. This paper attempts to provide in depth description of VC investment and how this type of investment helps to change or transform corporate governance activities within VC-backed firms. The situation in Ghana is based on simple responses provided by some VC firms operating in the country. It is believed that the paper will set the pace for serious research into VC investment in Ghana. The study is premised on the complementarities and the agency theory.

Venture Capital Investment Process

Venture capital investment is a process that involves mobilisation of funds, financing high-risk projects by entrepreneurial firms in specific industries with stated project lifespan and expecting high returns at exit. Sourcing of funds and investment (disbursement) activities of VC firms differ with respect to the economic and financial structure of the country (Mayer et al., 2002). Countries such as Germany, which is bank-based economy, VC investment is concentrated at the late stage with less investment in the technology industry. However, VC firms which raise funds from pension funds and insurance companies prefer to invest in the early stage firms. However they focus on low technology projects and concentrate their investment activities domestically to reduce risk. Individuals and corporate entities are willing to invest in early stage high technology projects and diversify to invest internationally.

Government-backed VC firms concentrate their investment internally and are willing to invest in early stages and in high technology firms. VC involves professional scrutiny of founders of entrepreneurial ideas and the returns viability of their projects to ensure that they finance only positive net present value projects (Fried and Hisrich, 1994). The fact is that VC investment is an important part of the entrepreneurial process such that with enough funds, new firms will spring up to promote economic development and growth.

VC firms are generally active investors (Puri (1996, 1999)) who monitor their portfolio (entrepreneurial) firms formally and informally to ensure the necessary corporate governance needed to effect the expected mutual benefit at exit. They monitor their portfolio firms formally when they serve on board of governors and informally through links with related institutions, such as banks. Bygrave and Timmons (1992) mentioned that VC firms provide business contacts and managerial training to their portfolio firms in order to ensure that the projects exit with profit. However, Hellman (1998) explains that some investment bankers make investment in VC firms in order to be engaged as underwriters at exit, especially when initial public offering is the preferred strategy.

Stages of Venture Capital Investment

There are generally two main stages of VC investment. They are the early and late stages .The seed and start up stages of VC investments form the early stage while the stages after the start up including expansion form part of the late stage.

According to Jeng and Wells (2000) the seed stage receives the initial finance as a newly founded entrepreneurial firm to conduct feasibility studies (research and development) to assess the commercial viability of the ideas. This stage is normally financed by the entrepreneurs themselves and in some cases by family members because most investors are interested in investing in products. At this stage, is also referred to as "zero P & C" since there is no product and no cash flow is generated.

At the start up stage, VC finances are received to finance actual products or work in progress to produce the product or service for the market. Firms at this stage may generate some cash flows but less than the investment cost. The startup "stage" provides the opportunity for VC firms to acquire expertise in allocating their resources to future potential start ups. Gompers (1994) explains that angel investors serve as an alternative source of funding for startups. "angels" are essentially wealthy individuals who finance startups out of their own funds.

While "Angels" represent an important source of financing, their scope is limited by the wealth of these individuals. "Angels" are not a viable source for large amounts of capital. Another source of startup financing is large corporations. Angel investors are limited in number. It is difficult to identify any of such investors in most developing countries, especially in Sub Saharan Africa. According to Yepez (2004), at the start up stage, it is common to have a proof-of concept or a working prototype that constitutes a formal technical development of the product. The entrepreneur may start to develop a business plan and marketing analysis that can help him look for outside capital. In many instances, angel investors are willing to invest in this stage because they have been entrepreneurs themselves and are quite familiar with the technology industry.

Startup firms generally operate in new markets, with less information about the nature of the market and have no established track records, which could be used as a measure of performance. In practice, startup firms have more intangible assets. As a result, their value lies in their potential for future growth requiring that their financial performance is monitored effectively. In this regard, Jensen (1993) "describes the type of investor needed in this environment as "active investor." This is because active investors are concerned with large financial interests in their investments in startups. They can provide effective decision driven management for the startups.

At the expansion stage, a firm has already established its product in the marketplace. It however needs extra capital to fund the growth of its manufacturing and distribution capacity; to fund further research and development (R&D), and to position itself strongly in the market place. Yepez (2004) concluded that VC investors are the main investors at this stage with increasing market share and on encouraging level of positive cash flows.

Mezzanine stage financing is part of the late stage in which investors search for an effective exit strategy. The venture would have typically reached a profitable level Banks and other financial institutions are typical investors at this stage. This is obvious because at this stage, the portfolio firms normally establish a pool of marketable tangible assets which can serve as collateral for bank credits for improved leverage. It is therefore not surprising to note that since most of the Ghanaian VC firms are financed by banks, they tend to concentrate their investment activities on existing small and medium scale enterprises (SMEs), which indeed limit the growth of entrepreneurship.

The usual exit strategies include Initial Public

Offering (IPOs), mergers and acquisitions (M + As) and leverage buyouts (LBOs). Venture capitalists may also invest at this late stage. However, the development of the capital market will determine whether initial public offering is an important exit strategy. The recent surge in initial public offerings (IPOs) in Ghana provides a promising effect of VC activities on the capital market.

Fund Raising

This is the first step in the VC process. They raise the funds within a certain specified period of time from individual investors and institutional investors. Pension plans and insurance contracts of individuals and institutions held with pension funds, insurance companies and banks are committed to VC funds being administered by VC firms. When the target amount is raised, then the next stage in the process follows. Currently, some of the VC firms are sourcing funding from external sources, Ghana Venture Capital Trust Fund (GVCTF), banks, Social Security and National Insurance Trust (SSNIT), other companies and individuals. However, it is still difficult for VC firms to raise funds from individual investors. GVCTF has recently organized a successful road show throughout the country to create awareness about the existence of the fund to be accessed by entrepreneurs and SMEs. Unfortunately, the VC firms have not staged specific programmes to attract investment from individuals to contribute to their fund raising activities.

Investments

VC firms or funds invest the funds committed to them by pension funds, insurance companies, banks, and individual investors in entrepreneurial firms with projects that promise high returns. VC firms may specialise their investment, in specific industries such as biotechnology, building technology etc. They may also decide to operate only at the start- up stage or expansion stage. Currently, almost all the VC firms operating in the country are skewed toward investment in the late stage. This does not help entrepreneurs interested in startups. The implication is that VC may not do much for the economy since most SMEs may not qualify for collateral embedded funding normally associated with late stage financing. The disbursement activity of the GVCTF concentrates on providing loans to SMEs which does not encourage equity investment in entrepreneurial firms.

Divestment at Exit

VC finance is time bound and the resources are considered as seed money that grows with time and should be harvested at exit. This process is normally called divestment. VC firms can exit with gain or loss. When exit occurs with gains, then the VC funds will distribute the residual income by making repayments and capital gains to the pension funds, insurance companies, banks, and individual investors who committed their resources to the VC funds. The institutional investors (pension funds etc) also pay back to holders of pension plans, insurance contracts and saving accounts. When the process continues then it is called virtuous cycle since it is yielding returns to the parties involve.

The governmental VC industry in Ghana has just completed the first element of the cycle (fundraising) and is in the process of disbursement or investing. It should, however, be noted that the fund raised for VC activities is undergoing the initial phase of disbursement. It is fully government funded through the Venture Capital Trust Fund. There are few official private venture capital firms currently operating in Ghana. They include Activity Venture Company Ltd, Gold Venture Capital, Fidelity Venture capital and Data Bank Venture Capital.

The nurturing of VC in Ghana is therefore very important. It demands that more professionals such as accountants, legal practitioners, engineers and finance experts come on board to build a strong alternative source of funding and to manage creative ideas. VC promises to contribute greatly to the development of the Ghana stock Exchange if portfolio firms adopt initial public offering (IPO) as their exit strategy.

The VC investment process is briefly

summarized drawing from Tybee and Bruno (1984) and sited by Yepez (2004) as a sequence of five key stages:

1) **Deal origination:** Prospective ventures or entrepreneurs enter VC firms by means of technology scans, referrals by personal contacts, or entrepreneur's direct approach. The deals are the entirety of business proposals well written by entrepreneurs for consideration by VC firms for funding.

2) **Screening:** Deals are screened based on salient factors such as stage of development, industry, and investment size. The VC uses experts to consider the business plans submitted by entrepreneurs as the first test.

3) **Evaluation:** If the deal reaches this point, extensive due diligence is performed on the company. Due diligence becomes an important professional exercise to ensure that only promising entrepreneurial projects are financed to gain at exit.

4) **Structuring:** When the decision to invest has been done, entrepreneur and the VC agree on the terms and conditions of the deal.

5) **Post Investment Activities:** At this point, VCs are involved in the management of the firm, usually playing roles in the board of directors. This will be an important challenge for entrepreneurs in Ghana since governance structures are weak and the owners usually do not want "interference".

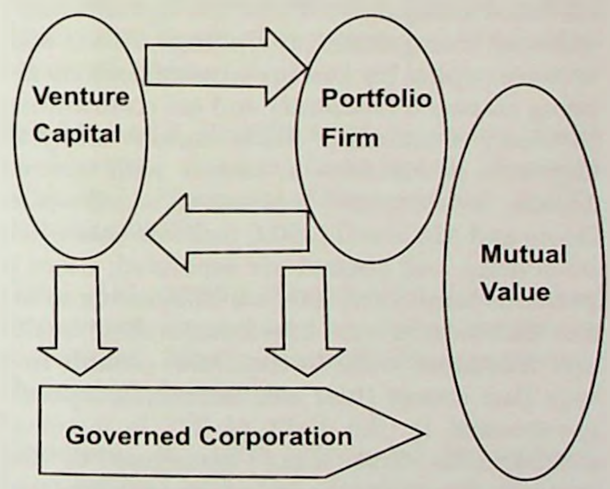
Complementarities Theory

There exists resource exchange between VC firms and entrepreneurs in which the firms exchange financial resources with innovative and technological knowledge of entrepreneurs. The incentive for the exchange process is the expected mutual value created at exit Gatsi, (2006). Complementarities therefore provide effective and supportive exchanges and effective decision management between VC firms and Entrepreneurs to generate end of project mutual benefits.

According to Maula and Murray, (2002) the heart of complementarities is the sharing of valuable knowledge such as extensive market and product knowledge that enhances market share and balanced management of the portfolio firms. When the vast experience and market-related information is combined with the active involvement in the management of the portfolio firm, mutual value added is created at exit. The diagram below shows the reinforcement of complementarities and governed corporation. A governed corporation implies that both VC firms and entrepreneurs shift from power-driven corporate governance to collaborative, joint decision making by both parties. When complementarities ideals and governed corporation principles are put together, the result is a successful exit which will benefit both the VC firms and the entrepreneurs, hence the mutual value as the product of the process.

The arrows show the interdependence between Venture firms and their portfolio firms. This interdependence and sharing of resources make both Venture firms and entrepreneurs committed to achieving individual but collective goals. This further produces effective decision making under the governed corporation paradigm.

Complementarities and Venture Capital Investment



Source: Adapted from Gatsi (2006)

The arrows show the relationship expected between entrepreneurial firms and VC firms complementing each other. When VC firms are represented on the boards of the portfolio firms with the inherent professional benefits, this will result in mutual benefits at exit.

Agency Theory

According to Jensen (1976) there is a principal-agent relationship between investors and corporate entities. In VC, the venture capitalist is the financier hence the principal while the entrepreneurial firm is the agent. The VC firms expect that entrepreneurial firms can be managed well to provide the needed mutual benefits. In this relationship, there is bound to be some level of information asymmetry to the disadvantage of the VC firms hence the active role being played by venture capitalists.

In this paper, the agency and complementarities theories are seen as reinforcing each other as displayed in figure 1 above.

Corporate Governance

Hochberg (2003) theorised that venture capitalists play major governance roles in their portfolio firms by closely monitoring the internal activities and providing valuable supports to management. McCahery and Vermeulen (2006) reviewed the corporate governance literature and give many comments on listed companies. There are equally many unlisted companies, including those with venture capital backed investments, which are being managed efficiently and are contributing to many economies. This makes studying corporate governance in sectors with venture capital investments interesting worthwhile. Denis and McConell (2003) indicate that when ownership and control are separated, there is potential conflict of interest. This is due to the fact that owners want to maximise their wealth and managers want to maximise wealth in a way that serves their self interest. Corporate governance in the light of VC is a set of mechanisms that make managers of the portfolio firms to make corporate decisions that will satisfy the interest of suppliers of capital and originators of innovative ideas. Board of directors, who act in the interest of shareholders, are entrusted with the power to hire, monitor, compensate, and fire where necessary to maximise shareholder value.

In the corporate governance structure under publicly listed firms, audit committees and compensation committees play important roles. Audit committees monitor the financial management and accounting process by interacting with management, board of directors, and external auditors. They also conduct inquiries into specific estimates and accounting issues to prevent fraudulent activities and bridge the gaps between management and external auditors. Compensation committees serve as independent units that determine and review remuneration packages so that management does not control and abuse the process and thereby ensure financial discipline.

From historical standpoint, corporate governance emerged as a result of the so called agency problem in which managers tend to be opportunistic by acting in their own selfish interest instead of shareholders and other stakeholders due to information asymmetry. Shareholders who are normally dispersed can not practically influence due diligence decision making that creates value, hence they delegate this responsibility to boards of directors. However, the monitoring and control cost are overwhelming and result in highly ineffective process.

Many researchers believe there is safe corporate governance among non- listed companies due to the legal restrictions and demand imposed on them by companies' codes around the world. According to Vermeulen (2003), the relationship between the entrepreneur and the Venture Capitalists is a form of principal agent situation where the entrepreneur is the agent and the Venture capitalist is the principal.

As a result of the above, many of the perceived problems of the venture capitalists are captured in the investment contracts. Entrepreneurs have monopoly over the ideas and knowledge they posses about the technologies and projects while the venture capitalist firms have monopoly over finance. This demands that venture capitalists monitor their investment, in the portfolio firms to avoid managerial opportunism and excessive risks. The monitoring costs are however very expensive such as creating huge compensation packages for managers and entrepreneurs. Venture Capitalists therefore monitor their investments by actively participating in the management of the portfolio companies. Their active participation is done through due diligence and establishing good relationship with the managers and sitting on the board of directors. In order to maintain acceptable levels of corporate governance, VC firms also provide other services such as consultancies, renegotiation of contracts, and legal counsel. In some cases they are not represented on the board of directors but influence the board decisions through board members who represent other investors whose businesses such Venture Capital firms have significant investments. From Venture Capital point of view, corporate governance is the process leading to achieving corporate goals through active participation.

Venture Capital Governance in Ghana

VC investment started in Ghana Since November 2004, with the enactment of the Ghana Venture Capital Trust Fund Law. The VC firms have indicated that there is prospect of improving the economy through venture capital activities even though entrepreneurs do not seem to understand the mechanism of VC. Some of the entrepreneurs who contacted them are interested in loans rather than equity investment in which VC firms own some stake in entrepreneurial firms. Interestingly VC firms are interested in between 45% to 50% stake in portfolio firms with average lifespan of five years. VC firms have also indicated that they are represented on the board of directors of their portfolio firms but do not seek to occupy the chair. However, there are clauses that empower the VC to take over management if the chief executive is not managing the firm well. They have stated that they also provide technical and managerial training to the portfolio firms and demand monthly report from them so as to closely follow developments.

Conclusion

The involvement of VC firms in financing entrepreneurial firms is transforming the level of corporate governance and managerial competence among entrepreneurs in Ghana. VC firms must therefore intensify their fundraising activities to be able to finance many entrepreneurs to spread their corporate governance influences further.

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