Seed Capital and Performance: Reflections and Way Forward for Micro, Small and Medium Enterprises in Kenya

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ABSTRACT

The study aimed at investigating the effect of seed capital on performance of micro, small and medium enterprises by reviewing related extant conceptual, theoretical and extant empirical literature. The study underpinning theories were; resource-based view, pecking order theory and theory of asymmetric information. The study employed literature review methodology. Based on the review of empirical research, it was concluded that seed capital contributes into developing a particular financing environment; where MSMEs can obtain angel capital from angel investors as well as equity capital from shareholders and crowdfunding, at the seed stage. More so, seed capital has an effect on performance of MSMEs supporting studies that found a positive effect. The seed capital, MSME uses to start a business, commonly comes from angel investors, owners' equity and crowdfunding. The paper recommends that MSMEs; first, need to obtain financing, obtain shared expertise and technical expertise from angel investors, should guarantee complete control through use of equity capital to preserve control and independence as they provide for reinvesting part of their profits.

Keywords: Angel Investors, Crowdfunding, Equity financing, Micro, small, and medium-sized enterprises, seed capital.

INTRODUCTION

Micro, small, and medium-sized businesses (MSMEs), because of their substantial contributions to employment and gross domestic product (GDP), are currently becoming driving forces behind long-term socio-economic growth (Muathe, 2010, Junaid Tufail, & Ali, 2021). Consequently, they are lauded for their contributions to sustainable development and promoting grassroots economic growth; contributing over 60% of GDP and generating 70% of jobs in developed economies. However, this varies across different context where while in United States of America, they account for approximately 52% of private employment and up to 52% of the GDP, In African continents they contribute well over 50% of GDP (Muathe, 2010) and in Kenya, they account for 81.1% of workforce, and contributed up to 33.8% of GDP (KNBS. 2017). In an effort to expand MSME sector, there is a push to ensure that new MSMEs provide a means to develop and apply new, practical ideas to specific situations (Al-Mubaraki, Hanadi, & Busler, 2017). Consequently, promoting new MSME businesses is becoming a top priority globally, and startup MSMEs are emerging as key drivers of growth and development (Ziakis, Vlachopoulou, & Petridis, 2022; Mahyuni & Rinaldi, 2022).

Nevertheless, MSMEs are facing financial challenges at the point of innovating and launching their products; adversely affecting their performance and hence limiting chances of survival (Mahyuni & Rinaldi, 2022). More specifically, MSMEs are unable to secure the funding they need to advance to the next growth stage; negatively affecting their performance (Mugambi, 2020). In addition to this, Kenya National Bureau of Statistics [KNBS] (2016) shows that 46% of Kenyan MSMEs closed their doors within the first year of operation as a result of subpar performance. Due to poor performance, only 30% of MSMEs in Uganda survive past their first three years of operation (Abaho, Aarakit, Ntayi & Kisubi, 2017) Noticeably financial restrictions and funding gaps for young MSMEs are brought on by capital market imperfections introduced by unclear investment gains, information asymmetry between business owners and prospective buyers, and a shortage of collateral (Umana, 2019). Early-stage financing, including the first and second rounds of funding, is a significant issue for entrepreneurs looking to improve their performance (Herber et al., 2017).

Agreeably, financial management theories that have been widely studied attest to the fact that, capital structure is a critical performance factor that fosters wealth expansion and result to enterprise growth (Myers & Majluf, 1984). In order to solve the fundamental problem of managing an enterprise's capital structure, the Agency Theory recommends that financial decisions be made with the cheapest source of capital as a priority. Notwithstanding, when costs are low and the perceived cost of equity is low, a business will indeed prefer debt financing over equity financing (Rishabh, Thakur & Mittal, 2016). Particularly, seed capital for new companies has demonstrated to be crucial for providing the necessary capital for conducting business and expanding funding opportunities for new MSME ventures (Herber et al., 2017).

Seed capital is the initial sum of money a business owner uses to launch a venture (Groenwegen & de Langen, 2012). Up until the point when an MSME business stabilizes its business, its capital is typically supported by seed capital. Typically, it covers costs up until the business starts to make money and attract more investors (Herber et al., 2017). Since there is no known past, established track record, or quantifiable indicator of success, lending institutions such as banks may be reluctant to indulge (Umana, 2019). The initial funding an entrepreneur uses to start a business, seed capital, frequently comes from angel investors (Levratto, Tessier & Fonrouge, 2018). shareholders (owners' equity), and crowdfunding.

Angel investors are crucial for MSMEs since they provide more than just financial support (Levratto, Tessier & Fonrouge, 2018). They are individual traders who provide their skills, knowledge, connections, and expertise to the businesses they invest in. They are successful business people with wealth to invest. in aiding MSMEs business owners in starting/growing their companies, they are eager to donate money, resources, and knowledge. One characteristic of angel investors is that they favor maintaining their secrecy. This quality hinders the realization of many ideas. To address this, many countries established networks and syndicates for angel investors. Entrepreneurs and angel investors can more easily connect through these networks and syndicates (Vismara, 2016). Usually, options for equity financing include operating cash flow, personal savings, gifts from family and friends, retained earnings, and deferred income (Njagi, Kimani & Kariuki, 2017). Complete control is guaranteed for SMEs with equity financing, and current shareholders are obligated to ensure that funds are utilized wisely, enhancing earnings reports. The primary factor behind this outstanding performance is the direct control existing shareholders have over their MSMEs. Furthermore, current shareholders must always ensure that the firm's resources are used efficiently due to their final say regarding dividend payments

Crowdfunding appears to be a potential additional, more effective source of funding for SMEs than traditional sources (Tomomewo & Akintoye, 2022). The owner could indeed raise modest sums of money through the technique of crowdfunding with the assistance of a large number of backers (crowd). Individual backers have made a number of small donations totaling the total amount of money raised. Through online platforms instead of conventional financial intermediaries, projects and potential backers interact most frequently (Zribi, 2022). In order to connect projects with investment firms, these platforms' funders primarily act as intermediaries and facilitators (Belleflamme, Omrani & Peitz, 2015). The various crowdfunding models are non-investment and investment models and the crowdsourcing investment strategies are equity-based and lending-based models (Mamaro & Sibindi, 2022).

Statement of the problem

MSMEs are considered to be an opportunity to speed the expansion of fast-growing enterprises worldwide and have consequently become a global phenomenon (Umana, 2019). Despite the substantial contributions they make to economic growth of most countries, Micro, small, and medium-sized businesses that are just getting started have limited financial resources available to maintain their performance (Hernández & Carrà,

2016; Turner, 2017, However, 50% of new small-business startups fail within the first 5 years of operation (Turner, 2017). This prevents most of them from growing past the startup stage for most of these businesses. This modest performance of MSMEs may be detrimental to the socioeconomic progress of most countries (Mugambi, 2020; Doran & McCarthy, 2017). Thus, inadequacy in early-stage seed capital is significantly affecting their performance (Umana, 2019; Okrah & Nepp, 2018). Thus, a significant barrier to the development and effectiveness of MSMEs occasioned is inadequate seed capital. seed capital is frequently insufficient to assist a startup in achieving its initial performance goals. Despite the fact that many scholars have looked into the relationship between seed capital and performance, the conceptual (Ka & Ab, 2019; Herber et al., 2017) and contextual (Stayton & Mangematin, 2019) limitations of the empirical studies that are currently available necessitate this study.

Objective of the study

i. To investigate the effect of seed capital on performance of micro, small and medium enterprises in Kenya

LITERATURE REVIEW

Theoretical Review

In this paper, the resource-based view (RBV) was found useful for underpinning the dependent variable; performance. Lockett, Thompson, and Morgenstern (2009), Wade and Hulland (2004), and Barney (1991) supported the RBV as the primary theory underpinning performance improvements. According to literature, in order to maintain its competitive advantage, a business needs to be able to dispatch clusters of resources (Teece et al., 1997). This is because core competencies provide a long-lasting competitive edge (Barney, 1991). RBV, which was established in the works of Wernerfelt (1984), Barney (1986), and Conner (1991) was built upon Penrose's (1959) work. It maintains that a firm's resources allow it to gain an edge over its competitors, which enhances long-term performance of the organization. According to the theory, resources ought to be valuable, rare (uncommon,) one-of-a-kind (inimitable), non-replaceable, and sustainable (VRIN) progressively over time (Barney, 1991).

Importantly, funding sources give a firm its capabilities when combined with resources, making the presence of capabilities a requirement for potential action (Dutta et al., 2005). As a result, the presence of capabilities automatically indicates the existence of finance. Financial resources are essential assets for improving better performance because they are difficult to transfer and imitate (Barney, 1991; Mahoney &Pandian, 1992).

The pecking order theory by Myers and Majluf's (1984) explains the manner in which entities rank the importance of raising new capital. According to this theory, using internal financing or retained earnings is the manager's initial preference. Internal financing alludes to the idea that a company can fund a venture using its own resources without issuing debt or equity. If the business does not have enough internal resources, external financing will be the second option. There is a preferred choice with the approval of equity as well as debt, and the distribution of external financing is split between the two. This theory contends that businesses are naturally inspired to use internal rather than external funds because of the higher costs of external capital brought on by these additional costs. Small businesses initially raise their own capital, but as their demands for capital rise, they borrow more to cover those costs. The need for external equity funding is brought on by the increase in financial requirements. According to this theory, businesses prefer to raise capital internally, and if this is not possible, they would first consider debt financing as an alternative source of funding before considering equity financing as an external source.

Small businesses generally adhere to the pecking order because it is difficult for them to get financing from outside sources. The POT put forth by Myers (1984) contends that businesses will favor raising internal capital in order to finance new investments before turning to debt or equity issuance.

Joseph Stiglitz (1961), George Akerlof (1970) and Michael Spence (1973) are the three proponents' economists who developed theory of asymmetric information which was formalized in 2001 (Matagu, 2018)). Based on the theory, then, new firms with higher levels of informational asymmetries would prefer internal finance, and friend and family funds (or owner finance for start-ups) as a first option (Taglialatela & Mina, 2021). Thus, new MSMEs would be comfortable using seed capital. Accordingly, when internal funds are exhausted, they would approach business angel and venture capital funds as sources of intermediate equity. This preference would be given because of the advantage that these sources have when coping with high levels of asymmetric information, while being cheaper than debt once non-monetary benefits are accounted for. Lastly, as they consolidate their collaterals, firms will have access to debt and public equity.

Information asymmetry is a main cause of workable problems in venture capital, where it is so prevalent (Melzer, 2017). Due to the existence of information asymmetry, investors' investment thinking and investment strategies are seriously affected, resulting in a great reduction in the benefits gained; thus, the problem of information asymmetry is also the most critical factor for investment errors. Due to the high returns and high-risk nature of venture capital, the consequences of the information asymmetry problem in it will be far greater than those in other industries.

Empirical Review

Various empirical studies on seed capital and performance are reviewed in this chapter. It captures specifically how angel investors, equity financing, and crowdfunding indicators relate to the performance of seed capital. In their study, Bonini, Capizzi, and Zocchi (2019) created a new performance metric and found that the existence of BA syndicates and their active participation positively impact on firm performance, while the level of angel monitoring and the timing of equity distribution have a negative impact. The results shed light on the various ways angel investors aid in the development and growth of emerging enterprises. The important findings demonstrate that the accomplishment and potential to survive are substantially enhanced by the presence of co-investing angel syndicates. Review on angel investors show the research by Levratto et al. (2018) as indicating businesses backed by Business Angels (BA) are significantly more likely to exhibit higher performance while the systematic literature review by Andersson and Lodefalk (2020) showed that business angels play a significant role in filling the equity funding. Despite a sizable body of research on business angel investing, few studies in-depth examine how it affects MSMEs' performance (Gregson et al., 2017). Plenty of the extant research exhibited conceptual and methodological flaws (Cumming & Vismara, 2017).

Research by Njagi et al. (2017) showed that MSMEs are guaranteed complete control with equity capital, and existing shareholders are obligated to guarantee that funds are used prudently, enhancing financial performance. MSMEs use equity capital to preserve control and independence because they dislike having access to outside financial assistance because it suggests less autonomy in managing the company's affairs. In their study, Jeong, Kim, Son, and Nam (2020) demonstrated that, a startup that succeeds in securing VC funding in its early stages sends out a positive signal that depicts its likelihood of success in the future. while Mwende, Muturi, and Njeru (2019) demonstrate a statistical relationship between equity financing and the performance of SME. Findings in research by Chindengwike's (2021) indicate that equity had a statistically significant negative impact on small business firms' financial performance in terms of Return on Equity (ROE) and Return on Capital Employed (ROCE), but a significant positive impact on their financial performance in terms of Return on Assets (ROA).

Tomomewo and Akintoye (2022), who examined the impact of crowdfunding on the expansion of SMEs in

Africa as part of their study found that crowdfunding is still in its infancy in Africa. According to the study, SMEs are the cornerstone of economic systems, and crowdsourcing is crucial to this. Research by Mamaro and Sibindi (2022) shows that crowdfunding campaign's accomplishment was significantly and favorably correlated with the average pledge amount and backer measure. Elsewhere, the study by Onyeka-Iheme and Akintoye (2022), Muathe *et al.* (2022) showed that the biggest challenges for African MSMEs are a lack of knowledge about the use of crowdfunding as a tool for raising money and the ease with which they can gain access to platforms for it, both of which have a significant impact on their development. The article by Zribi (2022) shows that investors are more likely to make modest donations to charitable causes while Eldridge, Nisar, and Torchia (2021) study findings show a significant positive relationship between crowdfunding and the potential for small businesses to grow.

Globally, SMEs struggle to raise capital, but in Africa they struggle even more because traditional funding sources like banks tend to favor well-established companies over these SMEs (Tomomewo & Akintoye, 2022). This difficulty explicates why MSMEs are unable to compete favorably. By decentralizing funding sources to fundraisers, crowd funding has emerged to fill these gaps. While there are currently very few academic studies on crowdfunding conducted globally, the majority of studies have been conducted in developed nations (Mamaro & Sibindi, 2022). Additionally, it was difficult to find crowdfunding literature that focused specifically on East Africa. Researchers like Wachira and Wachira (2021) and Zribi have identified gaps in the literature that are filled by this study (2022). In addition to Eldridge (2021) Studies on the effects of crowdfunding performances have been conducted, but they were only conducted in developed countries; as a result, their results might not be applicable to East Africa. The current study uses Africa as its analysis' focal point in order to address these studies' flaws.

RESEARCH CONTEXT AND METHODOLOGY

The study employed literature review of existing relevant literature. Literature review methodology include inspecting the literature, analyzing secondary data, and generating a reference list so that all articles are arranged and easily accessible to all (Tawfik et al.). It was the most suitable and pertinent to the study because it enabled the integration of findings and perspectives from numerous empirical findings to address the research objective that the researchers addressed.

FINDINGS AND DISCUSSION

In accordance with a review of empirical research, it was concluded that seed capital contributes to developing a particular financing environment; where MSMEs can obtain angel capital from angel investors as well as equity capital from shareholders and crowdfunding, at the seed stage. The finding show that seed capital has an impact on performance; supporting studies that found a positive significant effect and disproves studies that proved otherwise. Contrary to some studies, this article reveals that the seed capital investment in MSME has an impact on its performance. It was established that performance determines survival of MSME as well as their success while MSMEs' success has been attributed in large part to funding. However, capital market imperfections introduced by unclear investment gains, information asymmetry between business owners and prospective buyers, and a shortage of collateral introduce financial restrictions and funding gap which limit MSMEs from secure the additional funding they need to succeed in their business.

Thus, adequate financing is a significant issue for MSMEs looking to improve their performance. It is for this reason that seed funding has demonstrated to be crucial for both providing the necessary capital for conducting business and expanding funding opportunities for MSMEs. Thus, initial sum of money the owner uses to launch a MSMEs, largely comes from seed capital. Up until the point when MSMEs begins selling products or delivering services, its financing is typically supported by seed capital. This is owing to the fact that since, there is; little or no known past, lack of established track record, or absence of quantifiable indicator of success, lending institutions are largely reluctant to indulge is advancing debt capital. The study concludes that the seed capital MSME used to start a business, commonly comes from angel investors. owners' equity and crowdfunding.

The study established that MSMEs need angel investors because they offer more than just financial support. Importantly, angel investors contribute their expertise, connections, and knowledge to the MSMEs they invest in. To close the investment funding gap, business angel investors contribute their own funds to startup companies' initiatives. Since business angels are not required to consider other interested parties or investment firms, the principal-agent problem in addition to lowering the risk of a potential poor outcome. With MSMEs working with business angels they produce more money, create more jobs, and suffer from fewer unexpected financial challenges. The important conclusions show that the presence of a co-investing angel investees significantly increases accomplishment and survival potential, providing greater chance of becoming high-growth enterprises. Thus, business angels play a critical role in bridging the equity funding gap and hence improved performance of MSMEs.

This paper states that MSMEs use equity capital to maintain control and independence rather than seeking outside financial assistance which suggests less autonomy in running the company's affairs, so with equity financing, SMEs are guaranteed complete control, and current shareholders are required to ensure that funds are used prudently, improving earnings reports. The primary factor behind this outstanding performance is the direct control existing shareholders have over their MSMEs. Thus, equity financing is crucial for MSMEs seeking improved performance since it promotes growth, advancement, and value creation. Outstanding performance can be attributed in large part to the direct control common stockholders have over their MSMEs.

Further, the paper posits that crowdfunding is a supplemental and potentially more effective source of funding for MSME. MSME could indeed raise small sums of money using the crowdfunding technique, where a large number of individual backers make a variety of small contributions totaling the total amount to be raised for the seed capital. Crowdfunding is the preferred method of raising capital for MSMEs and business owners due to the external control mechanism and the absence of a collateral requirement

CONCLUSION

It was concluded that seed capital contributes to developing a particular financing environment; where MSMEs can obtain angel capital from angel investors as well as equity capital from shareholders and crowdfunding. Importantly, seed capital has an impact on performance of MSMES, Thus, initial sum of money the owner uses to launch a MSMEs, largely comes from seed capital. The seed capital MSME uses to start a business, commonly comes from angel investors. owners' equity and also crowdfunding. Thus, business angels play a critical role in bridging the equity funding gap and hence improved performance of MSMEs. Equity financing is crucial for MSMEs seeking improved performance since it promotes growth, advancement, and value creation. Outstanding performance can be attributed in large part to the direct control common stockholders have over their MSMEs. Crowdfunding is the preferred method of raising capital for MSMEs and business owners due to the external control mechanism and the absence of a collateral requirement.

RECOMMENDATIONS

Based on the findings from the empirical review, the paper recommends that MSMEs should develop policies for accessing seed capital form angel investors since they are the most risk-averse investors, underscoring the critical importance of capital appreciations. Secondly, MSMEs should guarantee complete control through use of equity capital, where its shareholders should be obligated to guarantee that funds are used prudently MSMEs should use equity capital to preserve control and independence. They should also review their policies on equity funding to incorporate retained earnings (reinvestment of profits) as a favored source of raising capital seed capital. Lastly, it is suggested that employing crowdfunding as among the preferred method of raising capital for business owners. They should strive on using reward-based model instead of accepting funds with the expectation of giving something in return

Limitations and Suggestions for future Research

Given the study was based on secondary data through document review the researchers call for further empirical research using primary data and a more robust research design such as explanatory research design to test the efficacy and enhance the reliability and validity of the current findings. Ultimately, the review highlights the importance of seed capital orientation in driving MSMEs performance.

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