

Venture Capital in Japan

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Abstract In business world, there have always been people willing to start business, and other people willing to back them and share the risks and rewards of enterprises, so in a sense there has always been entrepreneurship and venture capital (VC). Despite Japanese VC has gone through ups and downs, Japanese VC continues to lead Asia and is second only to USA. Japanese government has recognized the economic benefits of fostering the creation and development of venture firms, and has applied themselves assiduously to the task of creating a supportive environment. Although relative to the U.S., the Japanese VC industry is still a young, small industry, in another word, it shows that there is still a substantial room for further development, which makes VC still a promising industry in Japan. This paper discusses the Japanese VC history, development trend and some new operation characteristics in Japan which give us a new perspective to understand the current development of VC industry in Japan.

Key words Entrepreneurship, Venture Capital, Venture Capitalists

1 Introduction

The Japanese VC industry which had learned a lot from the U.S. proved to be still a young and small industry. When the first VC firm was established, VC was not known in the Japanese business world. When Japanese Venture Capital Association (JVCA) was established in 2001 by the effort of VC's persons, VC was recognized as the front-line financial activity. VC movement in Japan continued to grow and eventually won its address in the financial world. It even expected to contribute to the revitalization of Japanese economy. Since then, Japanese VC has gone through ups and downs, and grown into a trillion yen industry. However, a trillion yen amount of VC's total investment balance accounts only 0.2% of GDP in Japan. If we compare it with the total financial assets of 1,400 trillion yen and foreign VC's balance of 30 trillion yen in the US (3% of its GDP), we can hardly claim that Japanese VC has developed suitably in its economy.¹ Nevertheless, Even though Japanese economy is acclaimed to have recovered since 2004, considering the existing regional economy and large income difference among people, it cannot be optimistic for the future. The economic recovery that represents a new era must be led by new industries. New industries require some amount of new investment like that of VC, in which Mrs. J. Jacobs described as "Development Capital"². It shows that there is still an enough room for further development, which makes VC still a promising industry in Japan.

2 The history of VC in Japan

The Japanese word "venture" (bencha) can mean something rather different from its English original. Even in English, of course, venture can be ambivalent. It usually refers to a daring undertaking for private gain. But there is a strong association between venture enterprise and advanced technology, and an implication that a true VCs takes technical risks as well as commercial ones. He supports biotechnology companies rather than hamburger chains.

2.1 Public venture capital firms

The first effort to develop VC came in 1963, when the first institutions designed specifically to provide equity finance for business were created by the Ministry of International Trade and Industry (MITI). Small Business Investment Companies (SBICs) were set up in Tokyo, Nagoya and Osaka, by the enactment of the Small Business Investment Law under MITI's initiative. Capital was contributed into these SBICs by both local government institutions and local financial institutions and companies. The law was inspired largely by the American Small Business Investment Act of 1958. But this program differed from the US SBIC program in that firstly in Japan it has the support of government, among the

25 billion yen set up capital, 2 billion and 5 thousand was contributed by government. Secondly, in Japan only three firms were formed, whereas in the U.S., by 1963, nearly 500 SBICs had been established. The majority of equity in these three firms was held by local governments, city and regional banks, insurance firms, stock exchanges, private corporations, and chambers of commerce. Their business is, not lending, but equity investment and this entitles them to be accounted VC firms. But in Japan, some complicated set of rules were set to SBICs. Regulations limited their investment to small, yet profitable, dividend paying companies, and further required that the investment be at least 15% of the total equity³.

Twelve years after the SBICs were founded, in 1975, MITI established the Venture Enterprise Center (VEC), the organization which conducted the surveys of the performance of medium-sized enterprises. VEC have two activities: the first is providing guarantees of up to 80% of the value of loans made by banks to allow small advanced technology companies to undertake technical development. Another activity is much more important. It has become the main source of information about VC in Japan. The main aim is to indicate the overall investment situation, such as the amount of investment and balance, and types of industry, and the investment performance measured by IRR (internal rate of return). Up to present time, information on Japanese VC is available only from two research sources; Nikkei Newspaper and VEC.

2.2 Private venture capital firms

In 1972, the first VC firm named Kyoto Enterprise Development (KED) was set up in Kyoto. Between 1972 and 1974, eight private VC firms were formed by major banks and security firms (four were formed by banks and four were formed by security firms) In other words, the major Japanese financial institution formed VC subsidiaries. So from 1970 to 1973, in these three years, Japan experienced its first VC boom. In 1973, the largest private VC firm that existing now named JAFCO was set up. The 1973 oil crisis recession combined with the difficulties caused by the lack of a market for unlisted securities ended the first expansion phase. The number of investment declined and the industry stagnated. At the end of 1979, there were no new VC firms was set up. However, of the eight firms formed, six survive until this day. So a VC industry was created, but it did not have sufficient success to become an important part of the Japanese political economy. Thus the firms remained small divisions in large Japanese financial institutions.

In the early and mid-1980s, the huge rise in U.S. VC market attracted Japanese attention and stimulated a second VC boom. From 1980 to 1985, 68 VC firms were founded. Especially 14 VC firms were set up in 1983, 26 VC firms were set up in 1984, 20 VC firms were founded in 1985. The major players in this boom were the stockbrokers and regional banks. The six pre-existing firms expanded their operations. Their goal was to use venture investing to create relationship with the SMEs (Small and Medium Enterprises). Their VC affiliates provided funding and underwriting to the SEMs with the goal of gaining access to these firms to provide other services. With the number of VC firms has risen, so has the scale of investment. Not only did the firms increase investment on their account; many of them set up investment cooperatives to attract funds from outside. The largest private Japanese VC firm, JAFCO, raised 65% of its cooperative funds from abroad and probably has 40% of all Japanese private VC at its disposal. However, the second boom declined as a result of the recession caused by the rise of the yen in 1986 and 1987 after the Plaza Accord. Once again, investment activity declined substantially as few new firms were formed or funded and willingness to lend money to new firms also declined.

On March 8, 2002, Japan's economy entered its third and longest recession since 1993, and GDP contracted by a sharper-than-expected 1.2 percent in the last quarter of 2001. In many respects, Japan is thought to have lost its former competitiveness and there is perceived to be a paucity of original and effective solutions to the country's economic problems. As such, people refer to the 1990s as Japan's "lost decade." However, a number of changes have been occurring behind the scenes. In 1994, paralleling the growth of the Internet and the upswing in the Silicon Valley economy, Japanese interest in the role of VC in facilitating new business formation and the support of start-ups was renewed. Japanese VC was facing its third VC boom. This time, however, the boom occurred in an environment of continuing stagnation of the economy. But government has introduced a series of liberalizing reforms

aimed at creating an environment more supportive of entrepreneurship and venture creation. These reforms entailed a series of amendments to the Commercial Code (where Japanese corporate law is found), as well as amendments to stock exchange and over-the-counter rules.

3 The operation characteristic

Japan has, since the Second World War, paid the closest attention to American commercial and technical developments, often in order to adopt them. The institutions which offer VC today are for the most part copies of America originals. But the Japanese VC industry is younger than that of the U.S., and there are significant differences between them. The industry in Japan is more concentrated than in the United States.

3.1 Corporate-affiliated firms

One striking characteristic of Japanese venture capital is that none of the leading venture capital firms are independent. Through independent partnership are used in Japan, the majority of the VC organizations are closely affiliated with corporations rather than independent. Many of the partnership are, in fact, operated as corporate subsidiaries. Among the top 25 venture capital firms listed in the Nikkei survey, 11 were the affiliates of banks, and 8 were the affiliates of securities firms; the rest were 3 semi-governmental institutions, 2 affiliates of non-bank financial institutions and 1 affiliate of a software company.⁴ These affiliated firms generally invest their own money rather than that of other investors. While the VC firms in the U.S, are usually limited partnerships in which one VC firm serves as general partner and manages a pool of invested money. The pool includes money invested by the general partner. These firms are called private independent firms.

3.2 Investment stage

Traditionally Japanese VCs invest in the later stage of a firm's growth. They rarely invest in new business. They prefer to buy the shares of relatively well-established enterprises. Unlike the United States, venture capital investing in Japan is not associated with an active monitoring role. According to 1998 survey by the VEC, the percentage of companies receiving investment that was from set up 5 years old was 26%, from 5 years to 10 years was 16.8%, and from 10 years to 20 years was 24.2%, while 20 years old or older was 30.4%. according to the figures provided by VEC, the percentage of the firms funded by VCs were more than 10 years old was over 50%.⁵ It may be explained by two reasons. The first one is the environment is hostile to small firms. Investors in new firms and start-ups have had to wait 20 years and more before they could sell their shares. Another reason is that most of them are interested not merely in capital gains, but in generating business for the large financial organization which sponsored them. The large part of the Japanese VC pool is controlled by firms associated with securities companies. So, few Japanese VC firms are capable of finding entrepreneurs and investing in new companies.

But with the 8 years development of VC, things were changed. In the past, one of the obstacles to the development of Japanese VC was the stringency of the criteria to be met before the shares of a company could be listed on a stock exchange or publicly traded. But in order to eliminate these difficulties and improve the flow of funds to new enterprises, the Japanese Stock Exchange and the Securities Business Association lowered the criteria for stock exchange listing and the standards required of companies wanting to have their stocks traded on the Over-the-Counter market. In 2006, the trend of earlier-stage investment increased grammatically. From figure 1, we can see that the percentage of investment in seed and early stage was over 50%.⁶

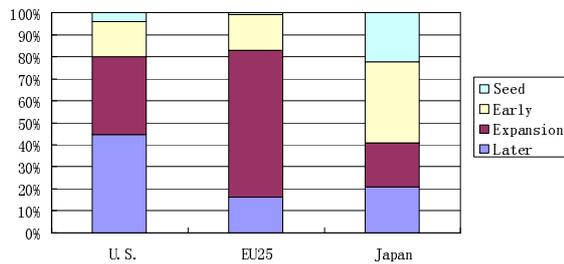


Figure 1 Investment stage of Japan, U.S. Europe

3.3 Investment sector and field

Compared the investment field of 1998 and 2006, the investment in the development field was increased greatly. From the survey of investment field of 1998, the total number of surveyed firms was 1281. The percentage of wholesale retailing was 13.4%, electronic manufacturing was 9.2%, the percentage of software firms was 13.4%, the percentage of manufacturing firms was 8%, while the firm that invests in the field of biotechnology was only with the percentage of 0.3%.⁷ But in 2006, it was changed greatly. From figure 2, the percentage of investment field in IT related was 34.8%, in biotechnology, medical and healthcare related was 18%. The total number of these two fields was over 50%.⁸

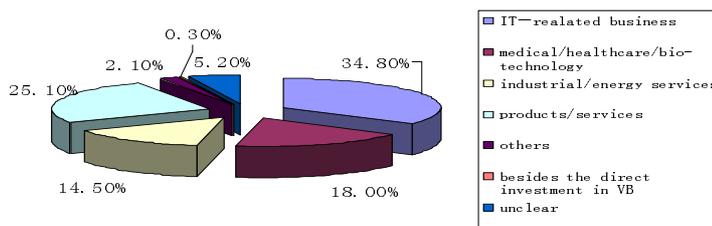


Figure 2 Japanese VC disbursements by industry sector

Another interesting thing we can made from the figure is that although it is often stated that bio-technology comes next after the IT bubble, it might be not true for the case of VC investment. IT industry still exists as large as 40%, with conventional type of industry capturing close to 40% of the pie. In contrast to this, bio-technology remains only 18% at most. The investment to bio-technology seems not to have increased much because long-term investment requires rigid conditions and special knowledge.

3.4 The exit way

For Japanese VC firms, the ratio of cases using IPO as an exit of investment was nearly 30%, which was higher than that of foreign VC firms. Even though the investment in the U.S. and U.K. tends to be made in forms of M&A and MBO, the main business still remains not in private-equity but in VC in Japan. If the trend continues, the so-called “junior market” should be prepared (to prevent scandals and promote IPO), and relevant markets should be inevitably unified. On the other hand, the rate of “resale to other shareholders or their original owners,” and “insolvency, dissolution and liquidation” amount to more than 30% combined. As a consequent, the second-hand market is also required.

3.5 The role of government

In the last few years, Japanese government has recognized the economic benefits of fostering the creation and development of venture firms, and has applied themselves assiduously to the task of

creating a supportive environment. What's more, the government is ambitious to plan to create a large number of venture firms and to focus on strategic industries. However, that merely creating venture firms, even in large numbers, is not enough if they are ultimately unsustainable. What is needed are more global-scale, sustainable companies, and so there is a need to ensure the growth of venture firms beyond a critical stage. To do so, however, require professional and specialized management teams, which are difficult for venture businesses to find in Japan and even in US, This is because of the low rate of labor mobility, the scarcity of managers who have received a leading-edge business education, and the fact that few managers are bold enough to embrace change and risk. So, an adventurous, risk-taking approach should be adopted to venture development.

4 Conclusion

A strong VC industry requires that both entrepreneurs and investors be willing to assume substantial risk. Despite its rich heritage of small firms Japan lacks the entrepreneurial tradition and culture of the U.S. a cultural shift in Japanese attitudes toward risk-taking and new enterprises is needed. Patience is not only necessarily a virtue in the VC world, particularly in Internet-related companies. By the same token VCs interested in funding Japanese start-ups and spin-offs should recognize that cultural changes and the establishment of a liquid market for the securities of new enterprises do not happen overnight. They should focus on good opportunities present within the evolving Japanese framework. But in all, Japan is becoming a more inviting place for start-ups and VCs.

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