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Venture Capital in Japan: A Financial Instrument Supporting the Innovativeness of the Japanese Economy

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JOLANTA MŁODAWSKA *

**Venture Capital in Japan: A Financial Instrument Supporting
the Innovativeness of the Japanese Economy**

Abstract

Venture capital (literally “high–risk capital”) is designated for the financing of small companies that by themselves lack sufficient resources, but whose activities indicate potentially high profits in the future. It can play a special role in the development of the technologically advanced industries as well as in the growth of entrepreneurship understood as a readiness to establish new companies (“start–ups”).

Two factors: First, the relatively small number of new companies as well as the number of companies subject to liquidation over the year (“firm turnover”) in Japan, and second, the insignificant prestige associated with the profession of entrepreneur do not foster growth in the dynamics of this form of financing ventures. The cited indicator for Japan is among the lowest in comparison with other highly developed countries¹, while the profession of entrepreneur is not the foremost dream of college graduates. They would much rather prefer realizing their professional careers as members of the government bureaucracy or employees of a major corporation². However, this mindset is slowly changing, if for no other reason than, in spite of popular conviction,

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¹ Grabowiecki J. (2000), *Japonia: powojenna dynamika i równowaga gospodarcza* [Japan: Postwar economic growth and balance], SGH Press, Warsaw, p. 221.

² Corver M. (2008), “Evolution of Japanese Venture Capital” Global Venture Capital inaugural lecture, p. 2,

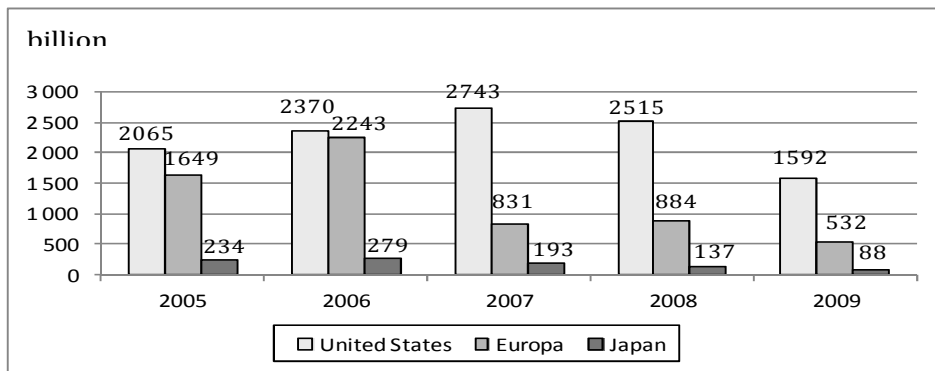
http://iis-db.stanford.edu/events/5317/Evolution_of_Japanese_Venture_Capital

because most small companies are not established during periods of prosperity, but near the end of the downward phase of the economic cycle. That is exactly the phase Japan has been dealing with for several years now. Young, creative people, recruited from the unemployed, are seeking self-employment, using all possible opportunities embedded in the “again starting up” machinery of the economy³.

1. Introduction

Perhaps, in addition to the relatively low public opinion of the profession of entrepreneur and the low “inter-generational” replacement of companies (“firm turnover”), there are two other phenomena determining the relatively small—as compared with the United States and Europe—level of involvement in VC investment in Japan. These two factors are the generally disdainful attitude of the inhabitants of the Land of the Cherry Blossom with respect to risk and actual, functioning legal regulations that impede the emergence and operation of VC companies. Figure No. 1 depicts the level of investment outlay on high-risk ventures over the years 2005–2009 for the United States, Europe, and Japan.

Figure 1. Venture capital investment in the United States, Europe, and Japan over the years 2005–2009 (billion yen)



Source: “2010 Survey Results on Trends in Venture Capital Investment,” Venture Enterprise Center, Japan, p. 3, <http://www.vec.or.jp/download/125>

³ Yonekura S. and Lynskey M. (2003), “Nothing Ventured, Nothing Gained,” paper presented at the Global Forum – Entrepreneurship in Asia: 4th U.S.–Japan Dialogue, April 16, 2003, available from the Maureen and Mike Mansfield Foundation, p. 11.

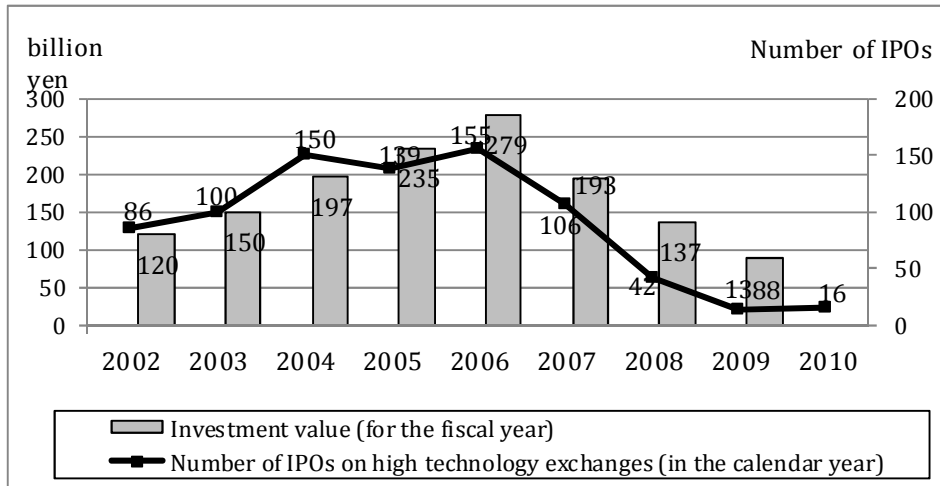
Analysis of data contained in Figure No. 1 indicates a falling trend in outlay in the case of Japan. An exception is the year 2006, when growth was noted. This is probably tied with the expansive monetary policy of that period and a short-term acceleration of the economy. The situation returned to normal following this “one-time incident” and the economy again plunged into recession. This was duly followed by a fall in VC investments.

2. Characteristics of Venture Capital (VC) in Japan

Figure No. 2 shows the shaping of high-risk capital expenditure in Japan in greater detail, including for the years 2002–2010—the first initial public offerings (IPOs) for Japanese high technology stock exchanges. Both indicators are seen to gradually grow over the 2002–2006 period following the breaking of the “Internet bubble” over the years 2000–2001. Starting with 2007, it is possible to note a successive drop in both. The dynamics of changes in VC investment is reflected in the fluctuations of the JASDAQ securities exchange index, where small and medium enterprises as well as VC companies are noted⁴. This is confirmed by the observation that the rate of IPO growth is, to a great extent, dependent on the state of the economy. It is relatively high during lively and blossoming phases and low during crisis and recession stages of the economy.

⁴ Six security exchanges are currently functioning in Japan—Tokyo, Osaka, Nagoya, Fukuoka, Sapporo, and JASDAQ. April 1, 2010 saw the merger of JASDAQ (including the segment of NEO—New Entrepreneurs’ Opportunity high technology companies) with HERCULES, which is a part of the Osaka exchange for new, innovative entities. JASDAQ, inclusive of the NIKKEI stock exchange index, remain the most renowned VC market. The others are MOTHERS, AIM, etc.

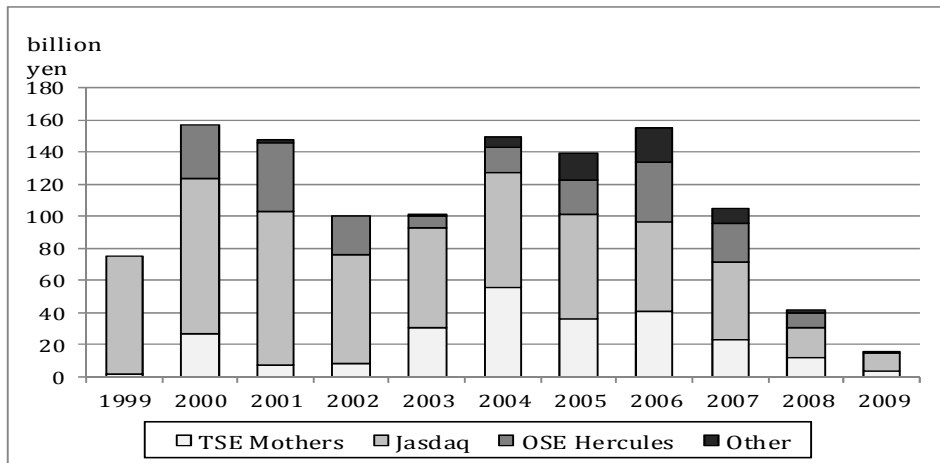
Figure 2. Venture capital investment in Japan over the years 2002–2010 (billion yen)



Source: “2010 Survey Results on Trends in Venture Capital Investment,” Venture Enterprise Center, Japan, p. 2, <http://www.vec.or.jp/download/125>

Figure No. 3 presents the number of initial public offerings financed using high-risk capital in Japan over the 1999–2009 period subdivided into concrete stock markets.

Figure 3. Number of initial public offerings (IPOs) of companies supported by venture capital in Japan over the years 1999–2009



Source: 12. OSE/JASDAQ merger’s significance and the future of Japan’s venture markets, NRI Financial Research Paper “lakyara,” Nomura Research Institute, vol. 78, p. 3.

T. Kirihata⁵ (2006) states that a lion's share of VC investment went to the processing industry, followed by food and beverage wholesale and retail trading (Table No. 1). In the United States over the same period the breakdown of outlay achieved using the same method was ultimately different and preferred software and information processing, tele-information technologies, and medical products (Table No. 2). The enclosed data again confirm the premise regarding the leading role, including in chronological sequence, of the United States in initiating technological progress and investment. However, changes should be noted on the Japanese side. For example, VC investments in biotechnology increased from 3.7% (the whole of outlay in 1998) to 7.7% in 2008. In their turn, VC investment expenditures on health care grew from 1.5% to 9.4% over the same period⁶.

⁵ Kirihata, T., "The Formation Process and Characteristics of the Japanese Venture Capital Industry," Working Paper, No. 113, Kyoto University, February 2010, p. 6.

⁶ Research was conducted by the Ministry of Posts and Telecommunications in 2002 and was subsequently repeated in 2008.

Table 1. VC investments in Japan (amounts and percentage shares) in billion yen in 1998

	Processing industry	Food and beverage wholesale/retail trade	Other services	Construction	Finance and insurance	Software	Information processing/Services	Telecommunications	Agriculture and forestry / fishing / mining
Levels of investment outlay (in absolute figures)	240.9	105.8	99.1	41	38.6	3.23	9.0	2.2	1.9
Levels of investment outlay(percentages)	42.2	18.5	17.4	7.2	6.8	5.7	1.6	0.4	0.3

Source: Ministry of Posts and Telecommunications (2000), p. 110, in T. Kirihata, "The Formation Process" op. cit., p. 6.

Table 2. VC investments in the United States (in billion dollars) in 1998

	Software/Information processing	Telecommunications	Medical products	Wholesale/retail trading	Biotechnology	Semiconductor manufacturing equipment	Computers and elements tied with computer manufacturing	Machine tools	Other
Levels of investment outlay (in absolute figures)	5.7	2.8	2.3	1.2	1.0	0.8	0.6	0.4	1.8
Levels of investment outlay (percentages)	34.4	17.0	13.7	7.1	6.2	5.0	3.4	2.3	9.2

Source: Ministry of Posts and Telecommunications (2000), p. 110, in T. Kirihata, "The Formation Process" op. cit., p. 6.

In their turn, Mayer et al. (2005) prove in their comparative study on VC investment in Japan, Germany, Israel, and Great Britain, based on *Nikkei Kinyu* (Financial Nikkei) data for sixty-two high-risk companies, that resources are primarily applied to the needs of the tele-information and software industry, with biotechnology, the life sciences, and environmental protection second. The authors contend that a relatively small share of outlay supporting the development of electronics and semiconductors as well as products and technologies from the processing industry (including chemicals) stems from the fact that most serious research and development work in Japan in this field is conducted in the laboratories of major companies of the “keiretsu”⁷.

3. The Entity Criterion for VC Investment in Japan and Its Importance to Efficiency

There are various sources of “venture capital” investment financing throughout the world. In the United States, the dominant role is played by the stock exchange and corporate investors as well as individuals—“angel investors.” Corporate investors are mainly recruited from among former executive or financial managers. Retirement funds (both state and private) are of significant importance in supplying high-risk financing, as are insurance companies. In Great Britain, the most frequently met sources are retirement funds, but also insurance companies as well as individual and government partners⁸. In economies where the financial system is based on banks (e.g. Germany and Japan), there can be an overwhelming preponderance of banks as the basic entity providing resources. This is the case in Germany. In Japan, it is the non-banking financial institutions that are of greatest importance (securities companies, credit card companies, leasing companies, and mortgage credit institutions), followed by banks and insurance companies. However, a large share of these is at least in part owned by banks.

A specific feature of activities in the high technology industries is the long period of return and the related uncertainty as to the final results (what is known as the “novelty risk”). This means that, in general, individual and corporate investors are more inclined to allocate outlay in these fields as opposed to institutional investors (banks, retirement funds, and insurance companies).

⁷ C. Mayer et al., “Sources of Funds and Investment Activities of Venture Capital Funds: Evidence from Germany, Israel, Japan, the United Kingdom,” *Journal of Corporate Finance*, No. 11, 2005, p. 593.

⁸ *Ibid.*, p. 587.

However, if that is the case, “crafty” banks, including Japanese ones, try to tie the financing of small innovative companies with their own main objective, which is the quick multiplying of money (more on this topic below).

The relatively small interest of banks in commercial credit for small hi-tech companies is linked with their weaker (as compared with major corporations) position in terms of assets. This translates into creditworthiness. Moreover, although new ventures may be characterized by high development potential, the discussed entities usually do not have real estate or other forms of security for loans at their disposal.

Although it is true that Japanese banks—when so requested by government financial institutions (Japan Development Bank)—agreed to accept intellectual property (brands and patent) as collateral (Yonekura and Lynskey, *op. cit.*, p. 3), the precise assessment of its value and low asset liquidity are a significant barrier. After all, banks prefer security that, if necessary, can be sold almost at a moment’s notice. On the other hand, intangible assets (e.g. patents) are subject to quick “depreciation,” especially in cases of an absence of developed trading markets and the Japanese system of protection for inventors, which is not overly rigorous. Moreover, high technology companies generally demonstrate long periods of research and development before any new product or new implementation makes its appearance.

In such a context, there is nothing strange in the fact that Japanese financial sector entities invest by way of specially created VC companies that are affiliated to them. There is also nothing strange in the concentration of outlay in later stages of project implementation⁹, just before the public debut of the new companies. This way, financial resources are frozen for a short period of time and support is given to companies whose success is “in the bag.” In the meantime, from the point of view of promotion of authentic progress, funds are necessary that will reward the risk, costs, and courage in the early stages of innovation (obviously after the presentation of a convincing business plan) at least in part.

If one subdivides the entire period of operations into four phases—(1) Seed money, (2) The establishing of new VC companies (start-ups), (3) A one to five year period, and (4) A five to ten year period—the United States is in the forefront with respect to involvement in the first and second phases, while the

⁹ Hellmann, T., Lindsey, L., and Puri, M., “Building Relationships Early: Banks in Venture Capital” (April 2008), *Review of Financial Studies*, Vol. 21, Issue 2, pp. 520–521, 2008. These observations apply to relations between banks and VC companies in the United States. They confirm the overall conclusion that in starting cooperation banks look to future profits—e.g. projections as to the possibility of granting credit. This principle is also in force in Japan (Kirihata, “The Formation Process ...,” *op. cit.*, pp. 8–9).

majority view in Japan is a “late appreciation” orientation. It is not without import that former bank officials hold seats on company boards. They, as claimed by Kuemmerle¹⁰ (1999), know how to assess the value of credit security, but lack sufficient general economic knowledge making possible the drafting of a good business plan or technical know-how that is prerequisite to the identification of promising advanced technology projects.

Table No. 3 presents the ten largest VC investors in Japan in 2007. Analysis of the data found in the table indicates that they are indeed giants in the Japanese financial sector. Thus, in their 2009 order, SBI Holdings (1999) is derived from Softbank Investment, JAFCO – Japan Associated Finance Co. Ltd. (1973) is affiliated with the Nomura brokerage house, and Mizuho Capital (2002) is tied to the Mizuho financial group, or more specifically, the Mizuho Bank. The remaining companies have a similar pedigree: Chuo Mitsui Capital was a company established as a subordinate of the merged Mitsui Bank and Sumitomo Bank (2002), while NIF SMBC Ventures is closely connected to the Daiwa brokerage house.

Table 3. Japan’s largest venture capital investors, 2007

Venture Capital	Investments (billion yen)
SBI Holdings	1170
Chuo Mitsui Capital	769
JAFCO	603
NIF SMBC Venture	370
Nikko Antfactory	239
JAIC	227
Mizuho Capital	90
Tokyo Marine Capital	81
ORIX Capital	80
Mitsubishi UFJ Capital	79

Source: M. Corver, op. cit., p. 4.

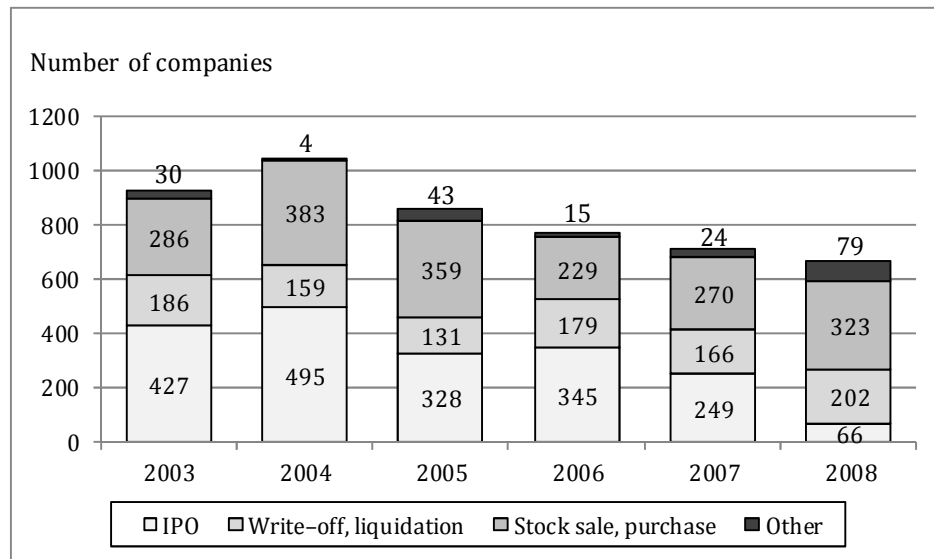
The only entity in the table that is not an “extension” of the financial sector is JAIC – Japan Asia Investment Co. Ltd. (1981). It was founded with the mission of supporting innovative advanced technology projects.

¹⁰ Kuemmerle W. (2001), “Comparing Catalysts of Change: Evolution and Institutional Differences in the Venture Capital Industries in the US, Japan and Germany,” Chapter 7, *Comparative Studies of Technological Evolution, Research and Technological Innovation, Management and Policy*, edited by R. Burgelman and H. Chesbrough, Amsterdam and Oxford, Elsevier Science, vol. 7, p. 36.

According to the VC Fund Benchmark Report, there were eighty-five high-risk capital companies in Japan in fiscal year 2007. They managed 451 funds (Corver 2008, p. 12). The average fund volume was approximately USD 40 million (after conversion). Fund resources were, on average, supplied by ten partners—investors.

The fact that it is primarily entities of the financial sector that are engaged in VC processes also finds its reflection in the characteristics of the methods used in withdrawing capital from the modern technology investment market (compare Figure No. 4). The most frequently applied form is the initial public offering (IPO). It is with the trading debut that the first profits make their appearance. These are consumed by the suppliers of funds. There are other methods that are less popular: debt write-off, company liquidation, stock repurchase by the investor, and the sale of the ennobled entity. It should be added that the last form is used particularly often in the United States, the country of origin of VC, because it is at that moment the investors in stock receive cumulative profits. In analyzing the data in the figure in detail it is possible to notice the falling number of IPOs (both in terms of relative volumes and absolute values). This may point to a growing role of other methods for withdrawing capital. It may also be the result of over ten years of recession in Japan.

The priority assigned to the IPO generally stems from the fact that financing by way of high-risk capital conducted by entities that have ownership ties with the banking sector and securities institutions remains in agreement with the goals of that segment of the economy—i.e. maximizing quick cash turnover. Thus, the mission behind these actions is not innovation and diffusion, care for the development of the co-created company, or the sale of patents and products for industry, but primarily the multiplying of profits.

Figure 4. Methods of withdrawing VC over the year 2003–2008

Source: *Venture Business Review in Japan, 2008–2009*, Venture Enterprise Center, Japan, p. 2, <http://www.vec.or.jp/download/114>

4. Legal Solutions in the Area of Financing High-Risk Capital

The first private VC company in Japan was established in 1972. Kyoto Enterprise Development, a “daughter” company of Kyoto Association of Corporate Executives, was created on the basis of American models (Kiriata 2010, p. 3). Its operations concentrated on support for the development of high technology small and medium enterprises in the Kyoto region. It made investments valued at approximately JPY 300 million in forty-two local corporations, financial institutions, and other entities listed on the Kyoto stock exchange over the eight years of its existence. Most probably, one of the major reasons for its liquidation was organizational excess when compared with similar ventures in the United States (as a rule made up of only a few private entrepreneurs in collaboration with financial institutions). The first investment fund was established by Nihon Godo Finance in 1982 (Kiriata 2010, p. 5).

Significant progress has been made in legislation governing the functioning of enterprises. Representatives of companies investing high-risk capital had no rights to sit on the boards of subsidiary companies prior to 1995, limited liability companies were not allowed up to 1998, and there was also

a ban on investment in retirement funds. There was no use of stock options as an instrument motivating management staff, too. With the introduction of amendments to the Commercial Code in 1997, permission was granted for the use of stock options in the case of the management of new advanced technology companies. The following year saw the introduction of laws allowing the creation of limited liability companies in this field in order to attract funds from institutional investors.

Successive solutions were passed in 2001. Up to that time a company was not allowed supplementary financing from the capital market from the start of the fiscal year of the planned public debut to the moment of actual registration (Yonekura and Lynskey 2003, p. 6). Moreover, all preferred stock as well as guaranteed and converted bonds had to have been transformed into stock (common stock) prior to the end of the fiscal year preceding going public. These requirements were executed even in situations where there was no certainty as to whether or not the IPO would actually take place.

The year 2002 saw further modifications to the Commercial Code. Regulations restricting the operations of small emerging companies were changed. The minimum price rule for issued stock (JPY 50,000) was eliminated. A similar rule relating to the minimum stock price following a split was also stricken. These regulations greatly restricted the liquidity of companies undertaking high-risk investments. Other rules complicating mechanisms for capital market financing were also removed. Principle 4:1. is one such example. It insisted that in each and every case of a new issue of stock, the volume of common stock could not be greater than four times the volume of preferred stock. Moreover, the actual ratio had to receive approval by two-thirds of the stockholders. Also eliminated were “draconian” (Yonekura and Lynskey 2003, p. 8) restrictions tying the rights to stock options with preferred stock as well as guaranteed and converted bonds.

5. Unsolved Problems

Apart from the lowest indicator of GDP share in VC investments of all OECD countries (OECD Economic Surveys: Japan 2011)¹¹ with a level of approximately 0.01%, among the most important unresolved matters is the already mentioned preference for incurring expenditures in the mature phase of the investment process. This is a characteristic quality of the activities of entities

¹¹ *OECD Economic Surveys: Japan 2011*, OECD Publishing, 2011, http://dx.doi.org/10.1787/eco_surveys-jpn-2-11-en, p. 93 (statistical data for Japan for 2006).

of the financial sector that minimize the period during which resources are frozen.

Other authors (Mayer et al., 2005, p. 593) point to insufficient internationalization of VC investments in Japan. Out of the fifty-five examined funds, 44% only allocated their resources domestically, 13% in a single region of the country, 38% less than one-half of outlay abroad, and only 5% more than one-half. Apart from the domestic orientation of VC activities, the small number of ventures with the participation of foreign partners is a cause for concern. Such participation is certainly not fostered by the 20% tax on the profits of mixed-capital limited liability hi-tech companies collected from foreign investors, introduced in 2007¹².

The last phenomenon that must be noted is linked with what is known as the “grandstanding” effect. It was observed by Gompers (1966, pp. 17–53) and described in the case of Japan by three economists—Getsu, Uchida, and Matsumoto (2007). Pursuant to the “grandstanding” hypothesis, newly established high-risk capital companies that as yet have no standing on the market are enticed into going public too quickly in order to build a standing. The case of Japan confirms this hypothesis. This is especially true with respect to independent companies that have no capital ties with the institutions of the Japanese financial sector.

An analysis conducted over the years 1986–2006 indicates that independent Japanese companies are listed on the stock exchange earlier and with lower share capital than other VC entities affiliated to the financial giants¹³. This tendency may be explained by the fact that, in contrast to their competitors, they do not have resources from a “mother” company or from the internal financial market of the given “keiretsu” industrial group. Lacking close ties with financial institutions, they must depend on external sources of additional capital. Moreover, it has been observed that independents, for the most part, make their debut on less rigorous markets—i.e. mainly MOTHERS (Market of the High-growth and Emerging Stocks), the floor for advanced technology on the Tokyo stock exchange, and HERCULES that, up to 2010, served similar entities within a part of the securities exchange in Osaka. The rigors of the most important hi-tech investment market—the JASDAQ securities exchange—are too difficult to meet in this case.

The fate of the AIM (Alternate Investment Market) is interesting against this backdrop. This is a new high technology market that was established as

¹² Compare M. Corver, *op. cit.*, p. 19.

¹³ Getsu S., Uchida K., and Matsumoto M., “The Dark Side of Independent Venture Capitalists: Evidence from Japan,” pp. 12–13, <http://ssrn.com/abstract=1928586>

a “joint–venture” of the Tokyo and London stock exchanges in 2008. It was founded after the Japanese corruption scandals of the nineteen–nineties and the bank crisis of 2007. The new market was intended to be different from MOTHERS with its significantly stricter registration criteria. Required on this market are transparency, accounting in agreement with international standards, listings in the English language, and observance of the requirement for company results to be public and for strict control over “insider trading” (illegal benefits derived from access to information about a company prior to its public listing, for example). According to data from the close of 2011, only one company—i.e. Mebiopharm Co. Ltd.—entered this market!

Significant underpricing of IPOs may be observed in the case of VC companies that are not linked to the financial sector¹⁴. To a great extent, this is the result of *ex ante* uncertainty with respect to the value of the company. It is a situation in which the price of company stock at the moment of its going public is lower than the market value because issuers are afraid of excessive risk. There is also a second aspect—long–term economic results. These also note significantly lower profits than in the case of companies acting in the name of financial giants (Wang, Wang and Lu 2003, pp. 2015–2034). Thus, both phenomena—the underpricing of stock prices in the IPO process and long–term results—seem to positively confirm the hypothesis of the “immaturity” of independent VC companies in Japan.

6. Conclusions

1. The role of VC investment in Japan measured as the share of outlay in GDP is not large and Japan itself is in last position from among OECD countries in this respect.
2. Most investments in the advanced technology industries, apart from the financing system, are also dependent on other factors such as availability of investment projects, alternative sources for financing innovation, tax incentives, legal regulations, the degree to which innovative activities are conducted by major companies, and overall macro–economic conditions.

¹⁴ Theories interpreting the phenomenon of IPO underpricing may be subdivided into those derived from the asymmetry of information (especially important in the hi–tech sphere), institutional, control, and behavioral. For example, Kirkulak et al. (2005, pp. 451–470) demonstrates that Japanese IPOs during the information technology (IT) boom of 1999 were significantly more underpriced than over other years.

3. The low rate at which new companies are established in Japan as well as their relatively small size seem to be a reflection of problems with credit by small enterprises. It is for this reason that the development of VC financing is considered to be favorable for both already existing small innovative entities and new technological start-ups.
4. Investment allowances should be proposed more broadly in order to utilize the potential embedded in high-risk capital companies, and the creation of databases relating to achieved results with respect to already operating VC firms. The adding of intellectual property to the arsenal of security instruments also seems to be a good solution.

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Streszczenie

VENTURE CAPITAL W JAPONII JAKO INSTRUMENT FINANSOWEGO WSPARCIA INNOWACYJNOŚCI GOSPODARKI JAPOŃSKIEJ

„Venture capital” (dosłownie kapitał wysokiego ryzyka) przeznaczony jest do finansowania małych firm, które same nie posiadają wystarczających zasobów, lecz ich działalność wskazuje na potencjalnie duże zyski w przyszłości. Szczególną rolę może on pełnić w rozwoju branż zaawansowanych technologicznie, a także we wzroście przedsiębiorczości, rozumianej jako gotowość do zakładania nowych firm („star-ups”).

Dwa czynniki: pierwszy – stosunkowo mała liczba nowych firm, a także firm likwidowanych w skali roku („firm turnover”) w Japonii oraz drugi – niewielki prestiż, jakim cieszy się zawód przedsiębiorcy, nie sprzyjają dynamizacji omawianej formy finansowania przedsięwzięć. Cytowany wskaźnik, dla Japonii należy do najniższych w porównaniu z innymi krajami wysoko rozwiniętymi (Grabowiecki 2000), zaś profesja przedsiębiorcy nie jest szczytem marzeń ludzi po studiach. Znacznie bardziej chcieliby oni swoją karierę zawodową realizować jako członkowie rządowej biurokracji lub pracownicy dużej korporacji (Corver 2008, s. 2). Ta świadomość ulega jednak stopniowej zmianie, chociażby dlatego, że wbrew popularnym przekonaniom, większość niewielkich przedsiębiorstw, powstaje nie w okresie prosperity, lecz pod koniec spadkowej fazy cyklu koniunkturalnego. Z taką fazą mamy do czynienia w Japonii od paru lat. Młodzi, kreatywni ludzie, rekrutujący się z bezrobotnych, poszukują samozatrudnienia, wykorzystują wszelakie szanse, tkwiące w „ruszającej na powrót” maszynierii gospodark (Yonekura, Lynskey 2003, s. 11).