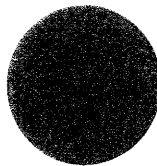


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The Japanese Venture Capital Industry

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Seth L. Hurwitz¹

Executive Summary

This paper examines the state of Japanese venture capital at an important juncture in Japan's economic development. It is meant to inform two audiences. The first is observers of the Japanese economic scene who may see repeated references to venture capital, but lack the broader understanding necessary to evaluate the significance—or lack of significance—of such references. The second audience is Americans who are interested in international private equity. In light of the highly developed nature of the U.S. venture capital industry and the huge funds raised by American VC firms, some experts wonder if there is “too much money chasing too few good deals” domestically. This accounts in part for the great interest that U.S. VC firms have shown in Japan recently.

This paper first provides some context for understanding the Japanese venture capital industry. It briefly discusses Japan's economic difficulties and the role of venture capital in promoting economic growth. It then sets forth a short history of Japanese venture capital. The heart of the paper is devoted to a discussion of the key features of Japanese venture capital. This includes information concerning the size of the industry, the players, the nature of Japanese VC investment, and performance results. This is followed by an analysis of some of the obstacles to a more vibrant Japanese venture capital industry. Throughout the paper, U.S. statistics, which are available in much greater detail, are referenced to provide perspective to readers more familiar with the United States venture capital industry.

The paper shows that relative to the United States, the Japanese venture capital industry is a young, small industry. It is highly concentrated and dominated by corporate-related firms that are unwilling for the most part to invest in new or risky businesses. Japanese VC firms have tended to invest in manufacturing companies, though high tech investments are becoming more significant. Fund returns have been mixed. While funds that have matured or been terminated outperformed both stocks and bonds, funds that are still in existence have achieved lower returns than bonds.

Obstacles to a more active Japanese venture capital industry include the difficulty of obtaining capital, a lack of financial incentives for entrepreneurs, and legal barriers. In addition, there are a relative paucity of viable exit strategies and significant cultural impediments to taking entrepreneurial initiatives. Recent developments, in particular Japan's continued economic problems, legal reforms, and increased interest on the part of VC firms, provide reason for cautious optimism.

¹ Seth L. Hurwitz is an associate at Enron Corporation. The views expressed here are my own and do not necessarily reflect those of Enron Corporation. I thank Michael Korver, Kuroda Naohito, and Richard Samuels for their suggestions and support and Erica Bess for her help with the graphics. Any errors are my responsibility. Comments can be sent to me at shurwit@ei.enron.com (as of October 11, 1999 comments should be addressed to me at shurwit@enron.com).

Introduction

Japan is struggling to revitalize its economy. Following six years of anemic annual economic growth of 1.27% from fiscal years 1992 through 1997 the Japanese economy contracted in FY 1998.² It may contract again this year. The Nikkei's strong rally this year—propelled by foreign rather than domestic purchasers—has only placed it in the 18,000 range, less than half of its peak ten years ago.

A Goldman Sachs' EVA³ analysis of Japan's Nikkei 300 non-financial firms over a ten year period provides stark evidence of the weakness of Japan's recent economic performance. Goldman Sachs concluded that these firms had experienced a negative 1.8% EVA spread from 1989-96.⁴ By comparison, firms comprising the S&P Industrials over the same period had a positive 0.95% spread over the same period.⁵ As one commentator on the report noted, Japan's firms have “been destroying shareholder value, on a massive scale.”⁶

One of the key factors in Japan's continuing economic slump is the inadequacy of its financial system to meet current needs. Japan has much less developed capital markets than the United States. Japanese companies have traditionally relied on loans from commercial banks and other financial institutions to meet their financing needs. Yet Japan's banks, long considered the anchor (“anka”) of its financial system, are saddled with hundreds of billions of dollars in uncollectable loans. They are more interested in retaining capital to meet more stringent capital adequacy requirements than in making loans.

The American experience over the last two decades provides strong evidence of how small and new businesses can create jobs and spur economic revitalization in a developed economy.

² The annual figures are given in Adam Posen, Restoring Japan's Economic Growth (Washington, D.C., Institute for International Economics, 1998), p. 49. Posen provides slightly different figures on p. 19. According to the U.S. Department of Commerce's International Trade Administration's Japan Country Guide (July 15, 1998), Japan's economy actually contracted by 0.7% in 1997.

³ EVA, an acronym for economic value added, is a registered trademark of Stern Stewart Co. It is an increasingly popular method of focusing on shareholder wealth creation through a comparison of cash flow and the cost of capital. A simplified EVA calculation is: $EVA = NOPAT \text{ (net operating profit after taxes) } - \text{Capital Charge}$. The capital charge is the discount rate (cost of capital weighted to reflect the particular firm's mixture of debt and equity) times net operating assets.

⁴ The negative spread came from an average return on capital of 3.9% compared with a weighted average cost of capital of 5.7%. Goldman Sachs Japan Research: EVA Analysis, Kathy Matsui, *et. al.*, May 1998, cited in James Shinn, “Corporate Governance Reform and Trade Friction,” Draft paper prepared for Council on Foreign Relations Study Group on U.S.-Japanese Economic Relations (March 1, 1999).

⁵ The U.S. firms had an average return on capital of 9.8% and a WACC of 8.85%. Goldman Sachs Japan Research: EVA Analysis, cited in Shinn, “Corporate Governance Reform and Trade Friction.”

⁶ Shinn, “Corporate Governance Reform and Trade Friction.”

From 1979 to 1995 the output of the Fortune 500 firms declined from fifty-eight percent of the gross national product to less than thirty-seven percent. During the same period, employment by Fortune 500 firms declined by over four million jobs. In sharp contrast, during this period the entrepreneurial economy generated twenty-four million jobs. Furthermore, approximately seventy-five percent of these jobs have been created by fewer than ten percent of small firms.⁷

Japan has had a very different experience. While it is true that among the OECD countries only Italy has as high a percentage of small firms and individuals employed in such firms, the proportion of Japanese working in small firms has been declining. One writer argues that although “small firms survived in large numbers later into industrialisation [in Japan] than in countries like Britain . . . Japan is experiencing a belated decline, or ‘delayed modernisation’.”⁸

A recent *Nihon Keizai Shimbun* editorial noted that the overall work force at firms with less than 500 employees “has shriveled since 1998, after decades of increase.”⁹ In fact, since the late 1960s the rate of start-ups, particularly independent companies, has declined.¹⁰ The number of small Japanese companies going out of business during fiscal 1997 was greater than the number of new companies established during that year. By contrast, since the 1980s U.S. business closure rates of over 12% have been more than matched by startup rates of nearly 14%. For this reason MITI argued in a white paper issued in April 1999 that revitalizing small businesses is essential to a Japanese economic recovery.¹¹

Many Japanese entrepreneurs have cited the problem of obtaining funding as the biggest obstacle to new ventures. Smaller and newer businesses in Japan have always faced significantly higher obstacles in borrowing and raising private sector money than their American counterparts. This problem is particularly irksome given the amount of private capital potentially available to Japanese entrepreneurs and businessman. Japanese individuals hold some 1,200 trillion yen (\$10 trillion)¹² in personal financial assets. This is over three times the market capitalization of the firms on the Tokyo Stock Exchange.

⁷ “Note on Angel Financing,” Stanford Business School S-SB-200 (1998), citing the Center for Venture Research.

⁸ Even in the manufacturing sector, as recently as 1993 the number of Japanese who were self-employed or working in firms with less than ten employees outnumbered those working in companies with more than one thousand employees. D.H. Whittaker, *Small firms in the Japanese economy* (Cambridge, Cambridge University Press, 1997 (paperback ed. 1999)), pp. 3, 33, 214.

⁹ “Real Job Growth Requires Startups,” *Nikkei Net Interactive*, August 2, 1999. The *Nikkei Net Interactive* and *The Nikkei Weekly* (referenced in fn. 11) are available online at <http://www.nni.nikkei.co.jp>. Unless otherwise noted, all *Nikkei Net Interactive* articles are from the *Nihon Keizai Shimbun*.

¹⁰ Whittaker, *Small firms in the Japanese economy*, p. 138.

¹¹ “White paper urges investors to fund new enterprises,” *The Nikkei Weekly*, April 26, 1999. See also “Wide-ranging incentives needed to encourage Japan’s start-ups,” *Nikkei Net Interactive*, April 13, 1999.

¹² All translations of yen to dollars in this paper have been made at the rate of 120 yen to one dollar.

Half of these assets are held in banks, the postal savings system and Japanese financial institutions in the form of deposits.¹³ The money earns extremely low rates of return. While Japan's high savings rate has long been considered a source of strength for the country, individual Japanese have been disadvantaged by their low returns on savings. These low returns are the result of a financial system structured to provide capital to large firms, particularly those in keiretsus or competitive in overseas markets. In the past this has included laws to limit the options of individual Japanese investors and to keep their capital within the country.

While this system helped Japan become an economic superpower in little more than a generation, in recent years it has helped stymie economic growth. Unproductive capital expenditures and Japan's economic difficulties show that Japan's savings have not been channeled to their most productive uses. For this reason, Japan's ongoing Big Bang ("Biggu Ban") has included measures designed to free up Japanese capital such as liberalization of rules governing investment trusts (mutual funds) and the ongoing deregulation of pension fund investment decisions.

Some Americans may view one solution to Japan's problems as self-evident: free up the huge amounts of private Japanese financial assets to support new businesses. A strong venture capital industry would be one component of a flourishing private equity market. While this reasoning is logical, it is essential to maintain perspective.

An August 30, 1999 article in *The New York Times*, while noting various obstacles to entrepreneurship, states that "Venture capital funds are forming like wildfire [in Japan], perhaps faster than the entrepreneurs can soak up the funds."¹⁴ People who conclude on the basis of the flow of private money into Japan and the country's technological and educational strengths that the Japanese venture capital environment is similar to that of the United States will soon be disappointed, however. Only by understanding how fundamentally different the Japanese venture capital industry is from its U.S. counterpart can one properly evaluate the potential effect of a larger VC industry on Japan's economy. Before we can do that, however, we must first look at venture capital generally.

The Role of Venture Capital Generally

New ventures have been a vital component of America's economic revival since the 1970s. Of course, these businesses have required capital. And while America's efficient capital markets have provided funds to mature companies, private equity has functioned as a means of channeling capital to less established businesses. Venture capital commitments

¹³ "Panelists see opportunity despite today's financial woes," *Nikkei Weekly*.

¹⁴ Sheryl WuDunn, "Japan Bets on a Wired World to Win Back Its Global Niche," *The New York Times*, August 30, 1999 (available online).

accounted for about 39% of private equity fundraising during the first half of 1999¹⁵ and now equal a quarter of all private equity.¹⁶

Like other forms of private equity such as angel investments,¹⁷ venture capital is premised on the notion that newer firms can permit equity investments but are less able to take on debt. The industry's risk/return profile reflects the fact that new enterprises are inherently different bets than are ongoing businesses that are funded through the capital markets. Investors in a successful new company can expect a high return that reflects the large risk they have taken. The Venture Economics Benchmark Return for U.S. venture funds from 1978 through 1997 was 22%.¹⁸ Because VC returns have been higher than those on investments in listed stocks or debt over the same period, there has been a huge rise in the amount of venture money available and in public awareness of the VC industry.

The U.S. venture capital boom has been concentrated on the high tech and information services industries. These industries represent a new, post-industrial revolution economy. America is today a leader in many cutting edge industries in large measure because of businesses such as Microsoft, Intel, Sun Microsystems and Dell that got their start through venture financing rather than the capital markets.

By contrast, despite its strength in many high technology areas, most notably automobiles and electronics, Japan often seems wedded to industries of the past. The system that led to such remarkable growth in the two generations after World War II seems to have held back Japan's ability to innovate during the 1990s. Over the last two decades Japan has not had the large numbers of successful new companies that mark the American economic transformation.

Given the positive role that venture capital has played in America's economic rebirth, some observers have urged measures to promote a more active venture capital industry in Japan. This will not only create greater funding mechanisms for start-ups and newer businesses, but also, it is hoped, serve to encourage risk taking in a culture that in recent years has frowned on risk. To better evaluate this argument it is useful to step back and look at the history of the Japanese venture capital industry.

¹⁵ The remainder was LBO commitments. *Venture Economics News*, "Private Equity Fundraising Takes a Breather," July 29, 1999 (available online). Estimates of these percentages vary. According to the National Venture Capital Association, "Venture funds represented 20% of the total private equity funds raised in the U.S. in 1997, compared to 22% in 1996 and 32% historically." National Venture Capital Investment Association 1997 Annual Report (Executive Summary), p. 2.

¹⁶ National Venture Capital Association. I thank John Taylor, Director of Research at the NVCA, for this information.

¹⁷ Angel investments are direct investments in companies by individuals.

¹⁸ Yale University Investments Office: November 1997, Harvard Business School Case No. 9-298-077 (rev. 1998), Exhibit 7. Similarly, Cambridge Associates, Inc. calculated the ten year time weighted returns to limited partners (net of fees, expenses, and carried interest) as of September 30, 1999 at 21.41%. *The Private Equity Analyst*, June 1999.

A Brief History of the Japanese Venture Capital Industry

The Japanese venture capital industry is younger than that of the United States. It dates back to the enactment of the Small and Medium-Sized Business Investment Development Company Law in 1963. This law permitted the establishment of semi-governmental venture capital firms called Small Business Investment Companies (SBICs). Under the law the Japanese national and local governments, as well as local financial institutions and businesses, could invest in category 28 businesses having less than 100 million yen in (paid-in) capital. Investments were limited to profitable, dividend paying companies and had to constitute at least 15% of their total equity at the time of investment. The investors could also provide investment and consultation services and could receive newly issued stock and convertible bonds in return for their investments.¹⁹

In light of Japanese industrial planning it is not surprising that the government envisaged directly assisting new businesses. As will be discussed below, the government's notion that it has a role to play in funding entrepreneurial ventures continues to this day. And significantly, although the Law permitted private investment organizations to participate in the SBICs, participating entities turned out to be financial institutions such as banks, securities companies and insurance companies rather than independent venture capital firms.²⁰

Japan's first private venture capital firms date back to 1972. Beginning in November of that year eight venture capital firms were established within a twenty-one month period. Other than the first of these firms, Kyoto Enterprise Development ("KED"),²¹ all were "kankeigaisha," affiliates of securities companies or banks. The most important of them was the Japan Associated Finance Co., Ltd, which was established in 1973 (see Appendix A). This firm, now known as JAFCO Co., Ltd. or JAFCO, is today Japan's largest and most well-known venture capital firm.

According to a publication by The Bank of Japan independent venture capital of the sort that we associate with the venture capital industry in the United States dates back to the late 1970s in Japan.²² However, the venture capital market stagnated until the second half of the 1980s, when the high tech boom led to a jump in VC activity that was led by VC firms affiliated with banks and securities firms.²³

¹⁹ The Bank of Japan Financial Research Center, Wagakuni no kinyuu seido ("The Japanese Financial System") (Tokyo, Bank of Japan, 1995), p. 401. Yasushi Hamao, Frank Packer, and Jay Ritter, "Institutional Affiliation and the Role of Venture Capital: Evidence from Initial Offerings in Japan," (April 1, 1998 version available online at <http://www.cba.ufl.edu/fire/faculty/ritter/ritteria.htm>), pp. 11-12. The Japanese title is "Chuushou Kigyou Tousei Ikusei Kabushikikaishahou."

²⁰ Wagakuni no kinyuu seido, p. 401.

²¹ KED was a creation of the Kyoto Keizai Douyuukai (Kyoto Association of Corporate Executives).

²² Wagakuni no kinyuu seido, pp. 401-02. JAFCO's 1998 Annual Report, however, states that the company set up Japan's first venture capital Partnership Fund in 1982.

²³ Wagakuni no kinyuu seido, pp. 401-02.

Major Japanese venture capital firms also invested heavily in Silicon Valley enterprises in the late 1980s and early 1990s. According to an advertising supplement in the magazine *Inc.*, “Nearly 40% of all venture capital invested in the U.S. computer industry in 1989 came directly from Japanese corporate coffers. In the electronics field, Japanese venture capitalists similarly provided roughly 25% of the total dollar investments in 1989.”²⁴

As had been the case with prior Japanese foreign direct investment in the United States, critics saw the inflow of Japanese money as a sign that Japanese investors were prepared to accept very low returns in order to secure technical knowledge and larger long-term gains. The most paranoid of them feared that Japanese companies, which did not have to disclose their limited partnership interests in U.S. VC firms, were using these investments in place of hostile takeovers to acquire U.S. technology.²⁵ Critics generally saw the inflow of Japanese money as the result of a shortage of patient domestic funds.

The buoyancy of the U.S. economy and Japan’s economic problems mean that one no longer hears these concerns. Yet, according to Venture Economics, JAFCO’s American subsidiary, JAFCO America Ventures, Inc., had the second highest market capitalization gain in technology IPOs in 1997, an impressive \$3.78 billion.²⁶ Its gains came from IPOs by Ciena, NeoMagic, and MMC Networks. JAFCO America has \$265 million under investment and plans to raise another fund at the end of 1999.²⁷

Distinctive Features of the Japanese Venture Capital Industry

The Japanese Venture Capital Industry is Much Smaller Than Its U.S. Counterpart

There are several estimates regarding the size of the Japanese venture capital industry. The MITI-affiliated Venture Enterprise Center stated in a 1998 study that as of March 31, 1998 venture funds managed 839 billion yen in assets (\$7 billion).²⁸ A MITI-sponsored study that was completed in December 1998 estimated that there were 211 VC funds in Japan

²⁴ “Japan and the U.S. entrepreneur: partners in progress” (Special Advertising Section), *Inc.*, October 1992, v. 14, no. 10, p. 169, avail. <http://web3searchbank.com/infotrac/session/256/994/3073256w5/84!xm> 45.

²⁵ See James Goldman, “VC community grows wary of Japan’s investors,” *The Business Journal*, January 29, 1990, v. 7, n. 41, p. 1 (available online) and Ray Wise, “Aggressive Japanese venture capital worries Silicon Valley,” *Electronic Business*, June 11, 1990, v. 16, n. 11, p. 57 (available online).

²⁶ Arete Ventures also had \$3.78 billion in market cap gains, while the leader, Weiss, Peck & Greer Venture Partners, had \$4.03 billion in market cap gains. The figures are provided in Stephanie T. Gates, “Don’t Look Down: The top 25 venture capital firms of 1997,” *Red Herring* (July 1998).

²⁷ JAFCO America prefers to invest \$1-4 million per transaction and generally invests in 12-16 new companies annually. See <http://www.jafco.com>.

²⁸ Non-Profit Venture Enterprise Center (Zaidanhoujin Bencha Entapuraizu Senta), “Summary of Present Venture Capital Investments” (Bencha Kyapitaru Joukyou Chousa Youshi) (1998). The VEC provides debt and equity to new ventures.

managing 690 billion yen (\$5.75 billion) in investments.²⁹ Finally, a *Nikkei* survey found that as of March 31, 1999 97 major venture capital firms managed 806 billion yen (\$6.7 billion), up 2.7% from the previous year.³⁰ However, both the *Nikkei* and the VEC surveys may have double counted some investments by corporate-affiliated VC firms.³¹ According to the *Nikkei* survey, 183 billion yen, or 23% of the total amount under management, was invested outside of Japan. Japanese venture capital investments totaled approximately 126 billion yen (\$1 billion) in fiscal year 1998.³²

The Japanese venture capital industry today is thus roughly the same size as the U.S. venture capital industry was in 1981 (\$5.7 billion). By the end of 1998, however, there were 547 American VC firms (1,108 funds), which managed \$84.2 billion.³³ There were \$10.4 billion in VC fund raising commitments during the first half of this year versus \$26.2 billion for all of 1998.³⁴ During the second quarter of 1999 alone, U.S. venture capital firms invested a record \$7.6 billion into new ventures—more than the total amount under Japanese management reported in any of the above-mentioned studies.³⁵

Corporate-Affiliated Firms Are Predominant

Not only is the Japanese venture capital industry much smaller than its American counterpart, its members are very different from American VC firms. From an American perspective the most striking characteristic of the Japanese venture capital industry is the prevalence of firms that are closely affiliated with corporations rather than independent. These affiliated firms generally invest their own money rather than that of other investors. Venture capital firms in the U.S., by contrast, are usually limited partnerships in which one VC firm serves as general partner and manages a pool of invested money. The pool often

²⁹ Ministry of International Trade and Industry, “1998 Japanese Venture Capital Funds Investment Performance Benchmarks Survey” (1998-nen Bencha Kyapitaru Fando (Toushi Jigyuu Kumiai) Pafomansu Benchimaku) (December 1998). This report was commissioned by MITI to the Financial Research Center of Nomura Securities Co., Ltd.

³⁰ “1998 Venture Capital Study,” *Nikkei Kinyuu Shimbun* (Japan Financial Daily), June 29, 1999, p. 18. The study was conducted jointly by the *Nihon Keizai Shimbun* and the Nihon Sangyou Shouhi Kenkyusho (Nikkei Research Institute of Industry and Markets). The *Nikkei* survey was sent to 157 major venture capital firms, including the SBICs, and usable responses were received back from 102 of these firms (several of whose funds were no longer in existence).

³¹ Double counting may have occurred because firms apparently were asked to give separate figures for “hontai” (direct investment by the firm for its own account) and “kumiai” (investment by the firm of money from a fund in which outside investors participate). Some VC firms such as JAFCO invest some of their own money in kumiai and may have reported it as both *hontai* and *kumiai*.

³² “1998 Venture Capital Study,” *Nikkei Kinyuu Shimbun*, June 29, 1999, p. 18

³³ National Venture Capital Association.

³⁴ *Venture Economics News*, July 30, 1999 News Release (available online). *Venture Economics News*, “Private Equity Fundraising Takes a Breather,” July 29, 1999 (available online).

³⁵ *Venture Economics News*, July 30, 1999 News Release, available online.

includes money invested by the general partner. These firms are called private independent firms.³⁶

According to the VEC study, as of March 1998 investments by companies (through funds) for their own account (“hontai”) made up almost 63% of Japanese venture capital (equity) investments. Investments by VC firms for others’ accounts (“kumiai”) accounted for the other 37%.³⁷ Investments included a small percentage of warrant bonds and convertible bonds.³⁸

The percentage of funds invested by these corporate-affiliated firms actually increased from fiscal year 1996, when it totaled 61% of all investment. And although the situation has begun to change, as recently as 1997 none of the top Japanese venture capital firms were independent. At that time the top twenty-five firms were composed of bank affiliates (11), securities firms affiliates (8), semi-governmental institutions (3), non-bank financial institution affiliates (2) and a software company affiliate (1). Five of the top ten venture firms in 1997 were affiliated with securities companies.³⁹

By contrast, during the second quarter of 1999 private independent VC firms accounted for \$5.05 billion, or 67% of total investment, in venture businesses in the United States. Partnerships affiliated with financial corporations and investment banks were the second highest investors, contributing \$1.04 billion (14% of total investment).⁴⁰

The difference between Japanese and American venture capital firms may have important consequences for the economy as a whole. VC arguably provides a countercyclical balance to the fortunes of large American companies within the larger U.S. economy. For example, the boom in venture capital that began in the early 1980s came at a time when the U.S. economy was mired in recession. Yet businesses like Microsoft, Dell and Sun Micro-

³⁶ The U.S. VC industry also includes firms that are affiliates or subsidiaries of financial corporations or subsidiaries of U.S. non-financial industrial corporations investing on behalf of their parents. These subsidiaries are called “direct investors” or “corporate venture investors.” National Venture Capital Association: “The Venture Capital Industry: An Overview,” available at <http://www.nvca.org/def.html>. U.S. VC firms are much more likely than their Japanese counterparts to commingle their investment with that of other investors in a fund that they are raising. Such investment by the general partner is viewed as a willingness to share risk and as a sign of confidence in the new fund.

³⁷ Non-Profit Venture Enterprise Center, “Summary of Present Venture Capital Investments” (Bencha Kyapitaru Joukyou Chousa Youshi), (1998).

³⁸ Some Japanese venture capital firms also loan money to new ventures.

³⁹ Hamao, Packer, and Ritter, “Institutional Affiliation and the Role of Venture Capital,” pp. 9, 12.

⁴⁰ The remaining investment was made up of corporations, corporate venture groups, SBICs’s, individuals, investment bank/financial corporations, and other investors. *Venture Economics News*, July 30, 1999 News Release (available online). By contrast, U.S. VC firms affiliated with investment or commercial banks have accounted for less than 25% of the dollars invested in private equity over the last quarter-century. Martin Smith: February 1998, Harvard Business School Case No. 9-298-076 (rev. 1998), p. 2.

systems that tapped the venture capital market at this time helped lay the foundation for the American economic revival.

By contrast, the Japanese venture capital industry has been hurt in recent years by the prominence of firms affiliated with banks and securities companies. These firms have retreated in the wake of the declining fortunes of their major shareholders. Investments by bank-affiliated and securities firm-affiliated VC firms fell by 38% and 35%, respectively, in FY 1998. The outstanding loan balance of VC firms also dropped by 24%. Likewise, prefectural support to venture capital foundations under a MITI-backed program that began in 1995 declined by over 50% (to 3.48 billion yen) in FY 1998. Investment by independent VC firms, on the other hand, increased significantly.⁴¹

Capital is Highly Concentrated

The predominance of corporate-affiliated firms has led to a concentration of capital in the Japanese venture capital industry. As of March 31, 1999, the following ten Japanese venture capital firms managed the most money.

**Top Japanese Venture Capital Firms Ranked By Amount Under Management
(March 31, 1999) (in 1M Yen)**

Rank	Name	Funds Under Management	Number of Portfolio Companies
1	JAFCO	181,844	1,594
2	Nippon Investment & Finance Co.	86,913	801
3	Japan Asia Investment Company	69,109	442
4	Nikkou Capital	41,422	578
5	Fuji Bank Capital	34,616	665
6	Tokyo Small and Medium Business Development Fund	33,468	772
7	Osaka Small and Medium Business Development Fund	26,705	613
8	Kokusai Finance	19,267	276
9	Tokyo Venture Capital	18,353	410
10	Diamond Capital	17,455	534

Source: *Nikkei Kinyuu Shimbun*, June 29, 1999

Together these firms managed about two-thirds of reported Japanese venture investments, with JAFCO (a staggering 22.6%), Nippon Investment & Finance Company (affiliated with Daiwa Securities), and Japan Asia Investment Company alone accounting for some 42% of the 806 billion yen total. In the U.S. the top ten percent of VC firms (i.e., about 55 firms) account for 57% of the total funds under management.⁴²

⁴¹ "1998 Venture Capital Survey," *Nikkei Sangyou Shimbun* (The Nikkei Industrial Daily), June 29, 1999, p. 18. "MITI Measures to Promote Start-Ups Produce Little Result," *Nikkei Net Interactive*, June 14, 1999 (from *The Nikkei Financial Daily*); "Prefectural Venture Capital Investment Slides to Half in FY98," *Nikkei Net Interactive*, June 2, 1999 (from *The Nikkei Financial Daily*); "Capital Gains by Venture Capital Firms Drop 10% In FY98," *Nikkei Net Interactive*, June 29, 1999.

⁴² National Venture Capital Association.

The following table shows that seven of the largest Japanese firms in terms of funds under management were among the top ten investors during FY 1998. Given the fact that in Japan industry rankings and market share often change little over a multi-year period this statistic suggests that the venture capital industry is more fluid than the norm.

**Top Japanese Venture Capital Firms Ranked By FY 1998 Investments
(March 31, 1999)**

Rank	Name	Amount invested (millions of yen)	Comparison with 1997 Investment	Number of companies invested in	Amount invested per target company (millions of yen)
1	JAFCO	27,175	(0.29)	170	159.85
2	Nippon Investment & Finance Co.	12,961	(0.45)	115	112.70
3	Worldview Technology Venture Capital	11,000	1.75	23	478.26
4	Japan Asia Investment Company	7,910	(0.49)	93	85.05
5	Nikkou Capital	6,152	(0.22)	62	99.23
6	Meiji Life Capital	4,056	0.67	68	59.65
7	Tokyo Venture Capital	3,352	0.33	35	95.77
8	Kokusai Finance	3,197	0.19	32	99.91
9	Diamond Capital	2,929	(0.17)	57	51.39
10	Daiwa Bank Company Investments	2,817	(0.02)	66	42.68

Source: Nihon Keizai Shimbun, June 29, 1999

The independent VC firm Worldview Technology Partners, the third highest investor during FY 1998, probably was not in the top twenty five in funds under management in FY 1997 (it is now 14th). Worldview, which invests only in the United States, invested an average of 478 million yen (\$4 million) per target company, three times as much as JAFCO, its nearest counterpart among the top investors. The establishment of new VC funds, which will be discussed later, presages continued change in the make-up of the largest investors.

Venture Capital Investments are Primarily Directed at Manufacturing Companies

As shown in the table below, forty percent of Japanese venture capital has been invested in manufacturing companies. Other major investment vehicles are firms involved in wholesale, retail, food and drink businesses (18%) and services (17%).

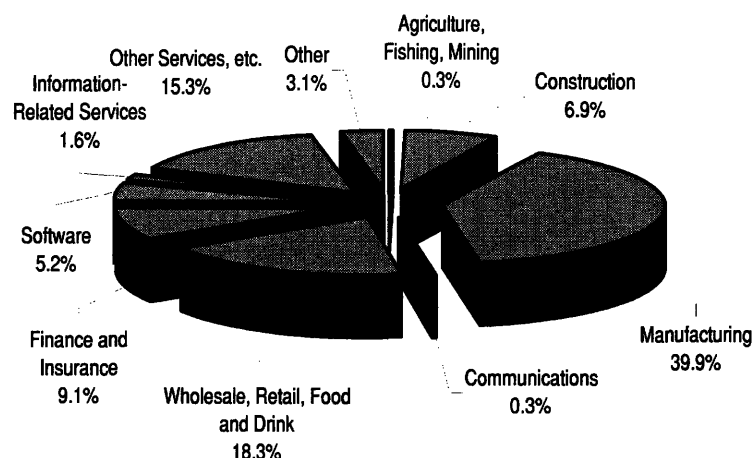
Industry Breakdown of Domestic Investment Balance (in 100M yen)

Industry Classification	03/31/1997		03/31/1998		Growth Rate		Makeup	
	No. of companies	Amount	No. of companies	Amount	No. of companies	Amount	03/31/1997	03/31/1998
Agriculture, Fishing, Mining	33	17	42	22	27.3%	29.4%	0.2%	0.3%
Construction	839	423	911	458	8.6%	8.3%	6.1%	6.9%
Manufacturing	4,700	2,792	5,063	2,664	7.7%	(4.6%)	40.3%	39.9%
Communications	45	14	77	21	71.1%	50.0%	0.2%	0.3%
Wholesale, Retail, Food and Drink	2,517	1,223	2,758	1,223	9.6%	0.0%	17.7%	18.3%
Finance and Insurance	582	665	584	610	0.3%	(8.3%)	9.6%	9.1%
Software	836	317	1,025	345	22.6%	8.8%	4.6%	5.2%
Information-Related Services	249	92	353	106	41.8%	15.2%	1.3%	1.6%
Other Services, etc.	1,884	1,153	2,167	1,018	15.0%	(11.7%)	16.6%	15.3%
Other	322	230	898	208	-	-	3.3%	3.1%
Total	12,007	6,926	13,878	6,675	15.6%	(3.6%)	100.0%	100.0%
Total High Tech-Related	1,034	621	1,323	670	27.9%	7.9%	9.0%	10.0%

Source: Zaidanhoujin Bencha Entapuraizu Senta: Toushi Joukyou Chousa Youshi

However, in spite of a 27.9% increase in FY 1997 only 10% of Japanese venture capital is invested in high-tech businesses. By contrast, some 78% of American venture capital is invested in high tech firms.⁴³ A pie graph is a useful way to compare the composition of Japanese and American venture capital investments.

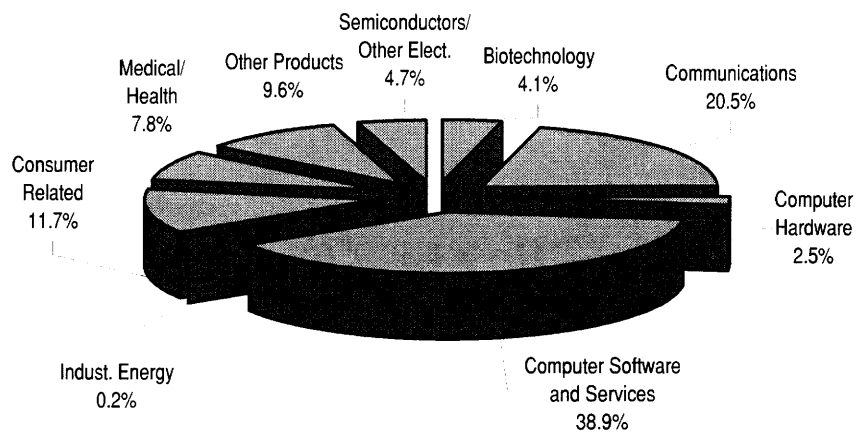
Japanese Venture Capital Disbursements by Industry Sector
(March 31, 1998)



Source: Zaidanhoujin Bencha Entapuraizu Senta: Toushi Joukyou Chousa Youshi

⁴³ National Venture Capital Association. See also the NVCA's 1997 Annual Report (Executive Summary).

**U.S. Venture Capital Disbursements by Industry Sector
(January-June 1999)**



Source: Venture Economics News, News Release, July 30, 1999

As the following chart from the Venture Enterprise Center shows, investment in manufacturing enterprises (46.6% in FY 1997) represents an even higher proportion of the Japanese venture capital that is invested overseas. However, high-tech related investment, 18.4% of the total, is far higher than is the case with respect to domestic venture investment and over 29% greater than in fiscal year 1996.

Industry Breakdown of Overseas Investment Balances (in 100M yen)

Industry Classification	03/31/1997		03/31/1998		Growth Rate		Makeup	
	No. of companies	Amount	No. of companies	Amount	No. of companies	Amount	03/31/1997	03/31/1998
Agriculture, Fishing, Mining	4	8	4	5	0.0%	(37.5%)	0.5%	0.3%
Construction	6	5	8	8	33.3%	60.0%	0.3%	0.5%
Manufacturing	348	621	428	728	23.0%	17.2%	42.6%	46.6%
Communications	14	21	13	17	(7.1%)	(19.0%)	1.4%	1.1%
Wholesale, Retail, Food and Drink	31	67	31	48	0.0%	(28.4%)	4.6%	3.1%
Finance and Insurance	78	154	84	156	7.7%	1.3%	10.6%	10.0%
Software	44	75	69	104	56.8%	38.7%	5.1%	6.7%
Information-Related Services	18	15	23	22	27.8%	46.7%	1.0%	1.4%
Other Services, etc.	88	300	88	307	0.0%	2.3%	20.6%	19.7%
Other	103	193	51	166	(50.5%)	(14.0%)	13.2%	10.6%
Total	734	1,459	799	1,561	8.9%	7.0%	100.0%	100.0%
Total High Tech-Related	189	223	233	288	23.3%	29.1%	15.3%	18.4%

Source: Zaidanhoujin Bencha Entaprizu Senta: Tousei Joukyou Chousa Youshi

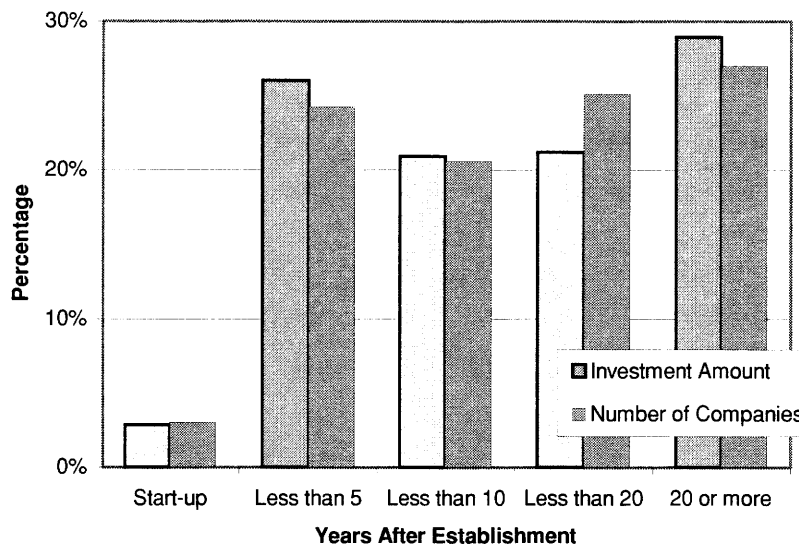
The VEC study does not provide a more detailed industry breakdown by region of Japanese venture capital investments. However, in light of what we know about the U. S.

venture capital industry, a good working hypothesis is that Japanese venture capital which is invested overseas in high-tech industries is invested primarily in the United States. Likewise, given the outsourcing of Japanese manufacturing operations in recent years, we can hypothesize that overseas Japanese VC manufacturing-related investment is focused on Asia.

Typical Portfolio Companies are Mature Firms

In part, the different investment profile of Japanese venture capital reflects the fact that Japanese VC firms are far less likely than U.S. VC firms are to invest in start-ups and other new businesses. The VEC study found that whereas almost 30% of new venture capital funding in Japan during fiscal year 1997 had gone into companies more than twenty years old, only 2.9% of funding had gone to start-ups. In the following graph, I show the breakdown by age of target companies of Japanese VC investment during 1997.

Recipients of Japanese Venture Capital During FY 1997



In the United States 28% of venture capital funding in 1997 went to seed and early stage investments.⁴⁴ Indeed, U.S. venture funds generally are raised to focus specifically on companies in particular stages of development.⁴⁵

⁴⁴ National Venture Capital Association. VC/private equity nomenclature can be confusing. Unlike “seed stage” investments, which refer to investment prior to the organization of a company or the existence of a real product, “early stage” investments refer to the next stage in the life of the company in which it requires further financing for product development and initial marketing. “Start-up financing” is another term for seed and early stage investments. “Medium stage” and “late stage” investments, as their name implies, refer to investments at subsequent stages of the company’s development. “First,” “second,” and “third” stage financing convey similar concepts. “Bridge” or “mezzanine” financing is capital for a company that expects to go public within approximately six to twelve months. See National Venture Capital Association: “The Venture Capital Industry: An Overview.”

⁴⁵ According to *Venture Economics News*, of the 112 venture funds raised during the first half of 1999, 4 were seed stage, 47 early stage, 37 balanced, 23 later stage, and 1 expansion. *Venture Economics News*, “Private Equity Fundraising Takes a Breather,” July 29, 1999 (available online).

Due to the tendency of Japanese venture capitalists to invest in mature, “safe” enterprises, the (domestic) recipients of Japanese venture capital are actually more likely to go public than are their overseas counterparts. For example, Nippon Investment & Finance Company’s chairman has stated that the firm once would not invest in companies less than ten years old.⁴⁶ One researcher estimated in 1997 that 58% of the venture capital investment in Japan, on an investment-cost weighted base, led to an IPO. The figures for the U.S. and Europe were 47% and 31%, respectively.⁴⁷

Japanese seed, early, and even medium-stage companies, however, have had difficulty obtaining venture financing. The latest statistics show that companies more than 20 years old accounted for 49% of total investment in fiscal year 1998. Companies less than 10 years old, meanwhile, accounted for 29% of total investment, down significantly from 1997.⁴⁸

Japanese venture capitalists’ relative lack of interest in younger companies may explain why they have traditionally not provided extensive advisory services for their clients. On the whole Japanese venture capitalists have the mindset of employees of a large, well-established corporation rather than those of a smaller firm who are attuned to the needs of a new business. Although a bank-affiliated VC firm may introduce a portfolio company to buyers and suppliers that do business with its parent, such firms do not manage actively on the scale of U.S. firms. Venture capitalists in America, however, view themselves as much more than financiers. They may conceptualize a new company and often take a hands-on role in managing the venture by serving as CEO or in another key capacity. U.S. venture capitalists bring much-needed operational or functional expertise to new companies.

VC Firms Have Increasing Number of Portfolio Companies

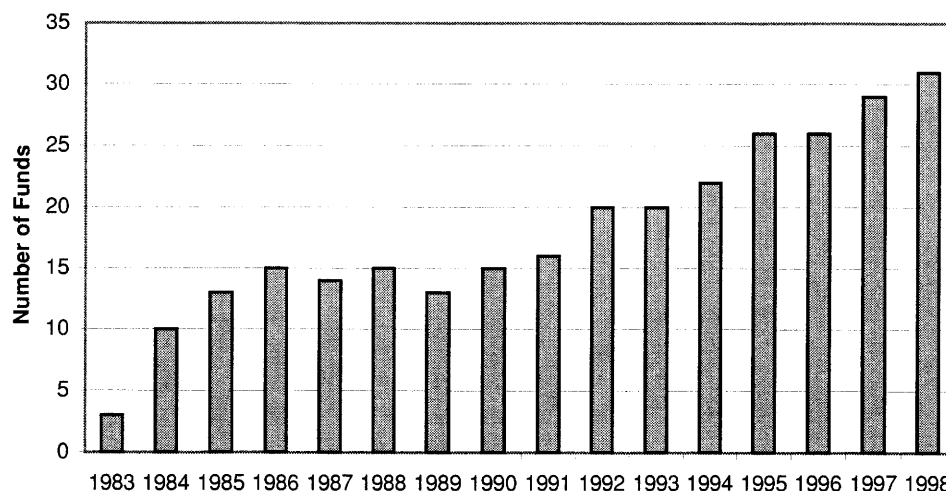
One important change that has occurred is an increase in the number of companies in which the average Japanese venture capital fund invests. Whereas in 1983 funds invested in an average of only three companies, that number had jumped more than ten-fold, to 31, by 1998.

⁴⁶ Sandra Sugawara, “Upstarts and Start-Ups: Japanese Entrepreneurs Gain Attention and Incentives, But Still Face Barriers,” *The Washington Post*, July 28, 1996, p. H1.

⁴⁷ Cited in Hamao, Packer, and Ritter, “Institutional Affiliation and the Role of Venture Capital,” p. 10.

⁴⁸ “Venture Capital Investments Down for the Second Consecutive Year,” (VC toushi ninen renzokugen), *Nihon Keizai Shimbun*, June 29, 1999.

Average Number of Companies Invested in by Japanese Venture Capital Funds



Source: Ministry of International Trade and Industry, "1998 Japanese Venture Capital Funds Investment Performance Benchmarks Survey" (1998-nen Bencha Kyapitaru Fando (Toushi Jigyuu Kumiai) Pafomansu Benchimaku) (December 1998)

This portfolio diversification arguably is a useful trend in an industry that is marked by the small percentage of ventures that become highly successful. However, as we will see, ongoing Japanese venture capital funds have gotten returns far worse than those of matured or terminated funds.

Fund Performance Has Been Mixed

The MITI study found that Japanese venture capital funds that had matured or otherwise been terminated had significantly outperformed listed stocks and bonds. The study examined 141 funds, which MITI believed made up more than half of all Japanese VC funds and 70% of the investment balance. Twenty four VC firms, none of which were independent, managed the funds. The funds had a weighted average return of over 10%, compared with returns of 3.4% for stocks and 6.9% for bonds over the same period.⁴⁹ Funds that had not matured or otherwise been terminated, however, had significantly underperformed bonds (a 1.64% average weighted return compared to 7.13% for bonds) though they had done better than listed stocks. While the standard deviation for VC fund returns was much higher than the standard deviation for bonds, as shown in the following table, it still appears low from a U.S. venture capital perspective.

⁴⁹ Ministry of International Trade and Industry, "1998 Japanese Venture Capital Funds Investment Performance Benchmarks Survey." At times the information in the report is difficult to use for comparative purposes. For example, the return on stocks does not include either dividends or investment costs. Bond returns also do not factor in investment costs.

Summary of Fund Performance

	Return Distribution					Simple Average Return	Standard Deviation	Weighted Average Return	Total IRR of Funds	Number of Funds
	Highest	Top Quarter	Median	Bottom Quarter	Lowest					
Expired Funds	17.56%	13.85%	9.20%	6.35%	3.20%	9.87%	4.47%	10.26%	10.09%	23
(Listed stocks over same period)	9.84%	6.79%	6.10%	3.82%	-5.72%	4.99%	3.66%	3.37%		23
(Bonds over same period)	7.88%	7.35%	7.09%	6.80%	6.22%	7.06%	0.41%	6.93%		23
Existing Funds	77.19%	1.76%	-1.01%	-3.16%	-12.37%	0.27%	9.01%	1.64%	2.36%	112
(Listed stocks over same period)	3.23%	-6.89%	-9.46%	-15.09%	-28.52%	-10.62%	6.10%	-9.60%		112
(Bonds over same period)	8.31%	7.55%	6.94%	6.43%	5.38%	6.94%	0.70%	7.13%		112
Funds in existence for more than 5 years	23.57%	6.33%	2.56%	-0.64%	-5.72%	3.75%	6.37%	3.24%	4.15%	81
(Listed stocks over same period)	9.84%	1.92%	-6.25%	-8.09%	-10.96%	-3.44%	6.28%	-4.94%		81
(Bonds over same period)	8.31%	7.69%	7.21%	6.84%	6.04%	7.21%	0.54%	6.67%		81
Funds in existence for less than 5 years	77.19%	-0.50%	-2.71%	-4.51%	-12.37%	-0.87%	11.71%	2.77%	11.25%	54
(Listed stocks over same period)	-6.25%	-9.81%	-15.16%	-17.74%	-28.52%	-14.73%	5.81%	-14.20%		54
(Bonds over same period)	7.66%	6.94%	6.53%	6.02%	5.38%	6.58%	0.64%	6.67%		54
All Funds	77.19%	4.22%	-0.07%	-2.85%	-12.37%	1.90%	9.14%	3.12%	5.54%	135
(Listed stocks over same period)	9.84%	-4.61%	-8.02%	-14.42%	-28.52%	-7.96%	8.23%	-7.38%		135
(Bonds over same period)	8.31%	7.48%	6.96%	6.52%	5.38%	6.96%	0.66%	7.09%		135

Source: Ministry of International Trade and Industry, "1998 Japanese Venture Capital Funds Investment Performance Benchmarks Survey"⁵⁰

MITI also provided a summary of fund performance by the year in which venture capital funds were established. The following table shows weak industry internal rates of return since the late 1980s, with the striking exception of 1994 where one fund's 77.19% return pushed the weighted average IRR for all funds up to 23.8%.⁵¹ The weak IRRs suggest that venture capital firms do not perform a countercyclical role in the Japanese economy.

⁵⁰ The report noted, however, that there were significant problems in calculating the market value of existing firms and in treating cash distributions to investors. It states that the market value of funds created under the Limited Partnership Act for Venture Capital Investment (November 1998) should be estimable in the future due to the methodology established by the Act.

⁵¹ The unique nature of the 1994 figure is shown by the fact that the standard deviation of the returns was over 30%, more than 23% higher than for any other year.

IRR Based on Year When Fund Was Established

Year Established	No. of Funds	Initial Funding (100M yen)		Simple Weighted Average IRR		Standard Deviation			Max	Min	Median	Weighted Average IRR	Total IRR				
		Ongoing	Closed	Ongoing	Closed	Ongoing	Closed	Ongoing					Closed				
1982	2		2	44.0		44.0	15.84%		15.84%	1.29%	16.75%	14.93%	15.84%	15.59%	15.61%		
1983	9		9	285.0		285.0	9.68%		9.68%	5.38%	17.56%	3.84%	8.38%	12.19%	12.96%		
1984	7	1	6	278.7	23.7	255.0	12.40%	23.57%	10.54%	5.87%	23.57%	6.33%	9.85%	12.93%	23.57%	11.94%	12.59%
1985	7	2	5	339.9	143.0	196.9	8.15%	9.67%	7.54%	6.98%	21.98%	1.09%	6.38%	10.85%	9.55%	11.79%	8.95%
1986	1		1	37.0		37.0	9.70%		9.70%		9.70%	9.70%	9.70%		9.70%	9.70%	
1987	3	2	1	180.0	137.0	43	6.69%	8.03%	4.00%	6.36%	12.86%	3.20%	4.00%	3.98%	3.97%	4.00%	3.91%
1988	9	3		275.0	275.0		-2.23%	-2.23%		2.31%	-0.07%	-4.67%	-1.96%	-2.71%	-2.71%		-1.85%
1989	8	8		543.0	543.0		0.60%	0.60%		2.83%	4.89%	-4.21%	0.66%	-0.78%	-0.78%		-0.61%
1990	12	12		926.4	926.4		0.35%	0.35%		2.38%	5.09%	-2.97%	-0.19%	0.61%	0.61%		0.72%
1991	15	15		696.0	696.0		1.40%	1.40%		3.39%	5.72%	-5.72%	1.04%	1.61%	1.61%		3.47%
1992	10	10		389.4	389.4		-0.45%	-0.45%		3.24%	4.91%	-4.84%	-0.60%	0.27%	0.27%		0.62%
1993	5	5		54.0	54.0		0.31%	0.31%		5.61%	9.07%	-4.69%	-2.43%	0.72%	0.72%		0.49%
1994	7	7		229.0	229.0		9.65%	9.65%		30.09%	77.19%	-10.66%	0.44%	23.80%	23.80%		37.82%
1995	11	11		404.5	404.5		-2.38%	-2.38%		3.64%	3.20%	-10.78%	-1.33%	-1.14%	-1.14%		-1.23%
1996	19	19		382.3	382.3		-3.34%	-3.34%		2.31%	2.77%	-7.72%	-3.15%	-3.68%	-3.68%		-3.55%
1997	16	16		419.6	419.6		-2.10%	-2.10%		6.15%	12.67%	-12.37%	-2.98%	0.78%	0.78%		0.52%

Source: Ministry of International Trade and Industry, "1998 Japanese Venture Capital Funds Investment Performance Benchmarks Survey"

The MITI study also found that on average venture-backed Japanese enterprises that receive venture capital begin repaying capital two years after investment. The payback period was listed as seven years. However, these calculations were in nominal terms.

Significant Obstacles to the Growth of a Strong Japanese Venture Capital Industry

Entrepreneurs and venture capitalists face a variety of obstacles that have prevented the emergence of a strong venture capital industry in Japan. These obstacles range from the concrete—financial and legal—to the abstract—cultural. They hinder fund creation and the establishment of new businesses.

Difficulty of Obtaining Financial Backing

It is much more difficult for new ventures to acquire bank financing in Japan than in the United States. Banks traditionally have focused their lending on large corporations. Even if they are willing to lend to smaller enterprises, they often require entrepreneurs to secure

their loans with personal assets.⁵² This not only makes it riskier to establish a new business, it also limits the ability of an entrepreneur who fails once to attempt to start another business.⁵³ In an article concerning the suicides of three businessmen who had faced bankruptcy, a Japanese attorney was quoted as follows. "Entrepreneurs know if they fail, they lose everything. If Japan doesn't limit personal liability in company bankruptcies it cannot nurture the entrepreneurial spirit it needs to survive. . . . Your whole personal life is wiped out if your business fails."⁵⁴ As for individual or "angel" investors, as a general rule Japanese investors do not understand the risk-return relationship inherent in investing in new ventures.

In light of their precarious cash position start-ups have even greater need of equity financing. However, this has not been widely available in Japan. In particular, growth in the Japanese venture capital industry has been hurt by the lack of long-term domestic institutional money, which fueled the huge expansion of the U.S. VC industry after 1979.

The U.S. Department of Labor's ("DOL") clarification of the "prudent man rule" in 1979 was a milestone in the U.S. venture capital history. Prior to this time, pension funds were concerned that venture capital investments violated government standards governing investments.⁵⁵ DOL's clarification ensured that losses on venture capital investments would not constitute a prima facie case that fiduciary managers were not being prudent. This resulted in a sharp increase in the amount of money that pension funds invested in private

⁵² It should be noted that small Japanese businesses have long enjoyed government support in the form of government-guaranteed debt, as well as lower taxes and below-market interest rates. New businesses have access to government-guaranteed loans via the MITI-supported Sangyou Kiban Seibi Kikin (Industrial Improvement Structure Fund) ("ISIF"). The ISIF provides a debt guarantee of up to 120 million yen (\$1 million) to a commercial bank, which then lends the money to the enterprise. It also provides equity to enterprises. The ISIF and the VEC are the main government backed organizations (other than government-affiliated VC firms) providing capital to venture businesses. The Small and Medium Business Credit Guarantee Association (Chuushou Kigyuu Shinyou Hoshou Kyoukai), also indirectly backed by MITI, provides some guarantees for lending directed at venture enterprises. It utilizes local Shinyou Hoshou Kyoukai (Credit Guarantee Associations) to conduct due diligence on applicants. Unlike the ISIF, it also lends to other businesses. The Association's guarantees are generally limited to about 50 million yen if the company has no collateral and 200 million yen if it does. However, it is unlikely that businesses which participate in the program will receive these maximum guarantees. I thank Kuroda Naohito for the above information. Start-ups' access to debt financing increased following the government's October 1998 decision to approve 20 trillion yen in loan guarantees for small businesses and start-ups. More than 16 trillion of this amount has been used to guarantee 920,000 loans since that time. The government is considering expanding the program. "Govt May Expand 20 Trln Yen Small-Business Loan Guarantees," *Nikkei Net Interactive*, August 29, 1999; "Govt To Guarantee Bonds Issued By Small Firms," *Nikkei Net Interactive*, September 12, 1999. See also Whitaker, Small firms in the Japanese economy, pp. 173-79.

⁵³ This point was made by MITI in its White Paper earlier this year. "White paper urges investors to fund new enterprises," *The Nikkei Weekly*, April 26, 1999.

⁵⁴ Mary Jordan and Kevin Sullivan, "Suicides, Depression Unveil Japan's Angst," *The Washington Post*, October 7, 1998, p. A1.

⁵⁵ See Martin Smith: February 1998, p. 2.

equity.⁵⁶ Institutional public and private pension funds now account for over half of U.S. private equity/venture capital investments.⁵⁷

Yet Japanese pension funds are only beginning to diversify their portfolios to include riskier investments. Meanwhile, the difficulty of obtaining financing at home has led several Japanese firms to establish a U.S. presence. For example, Digital Garage, a Japanese Internet portal provider, moved to Silicon Valley in order to seek new financing. Smart Valley Japan, the Japanese chapter of a nonprofit group based in Silicon Valley, announced plans to incorporate in San Jose in January 1999 in response to the increased numbers of Japanese entrepreneurs and new companies seeking to raise capital and develop new markets in the United States. Smart Valley hopes to sign up 50 corporations and 170 individuals this year.⁵⁸

Lack of Financial Incentives for Managers

The prevalence of securities firm- and bank-affiliated venture capital firms in Japan means that important incentives that drive U.S. venture capitalists are not present in Japan. American fund managers receive a management fee, typically 2-2.5% of the capital invested. This gives them a strong incentive to raise large funds, particularly since their fixed costs will shrink in percentage terms as the size of the fund increases. Moreover, they receive further compensation as a result of their carried interest percentage (typically 20%) in the fund's investments.⁵⁹

By contrast, Japanese fund managers, at least in corporate-affiliated firms, do not receive performance-based compensation. Consequently, they need not justify their performance in the same manner as American venture capitalists. And without the need to establish a follow-up fund, they lack another important incentive to perform. It stands to reason that individual managers who receive the same salary no matter how their fund performs have much less of a stake in finding good ventures. The potential downside in taking risks is much greater than the potential upside. Japanese managers are therefore likely to avoid risky ventures such as start-ups.

This problem is exacerbated by the fact that VC firms affiliated with Japanese banks and securities firms are managed by "shukkousha," individuals seconded by the parent corporation to their venture subsidiaries for 3-4 years. These managers not only lack VC experience, they also have a strong incentive to avoid taking risks that could jeopardize receiving the normal promotion at the end of their assignment.

⁵⁶ Martin Smith: February 1998, p. 2.

⁵⁷ National Venture Capital Association: "The Venture Capital Industry: An Overview."

⁵⁸ "New Group to Support Japanese Entrepreneurs in US," *Nikkei Net Interactive*, January 5, 1999.

⁵⁹ "Carried interest" refers to the general partner's percentage of the profits earned by the venture fund.

Legal Barriers

Entrepreneurs and venture capitalists are affected significantly by the legal regime under which they operate. For example, U.S. venture capital funds are structured primarily as limited partnerships in order to limit the liability of the investors.⁶⁰ This structure makes it easier to insure that a fund will dissolve at the end of a stated period. However, Japan, like other Asian countries, did not permit limited partnerships for many years. Liabilities have therefore been legally unlimited. This apparently explains why all but one of the 102 firms listed in the *Nikkei's* June 1999 study are corporations. The one exception manages only 38 million yen.

The lack of limited liability for limited partners was a significant obstacle to investments by pension funds and certain other types of investors. Only with the passage of the Limited Partnership Act for Venture Capital Investment⁶¹ in November of 1998 was the limited partnership form of corporate organization permitted. The Law makes limited partners liable for partnership obligations only to the extent of their capital investment.

Startup companies often cannot afford to pay high salaries to attract executives, managers, and other employees. One solution is to provide employees with compensation packages heavily weighted toward stock options. Stock options align the interests of employees with those of financiers. In return for the risk that the firm will be unsuccessful, employees can envisage a very lucrative payout in the event of a successful exit strategy such as an IPO or the sale of the company at a premium to another firm.

However, while this compensation tool has long been common in the U.S., it was not permitted for many years in Japan. More recently, Japan allowed corporations to issue stock options—but only if they first applied to the government and were recognized as viable issuers. However, MITI permitted only a handful of companies to issue options in this fashion.

Finally, in June 1997, issuers were allowed to forgo the application process and to issue up to 10% of their shares in the form of options.⁶² However, only a few new ventures are using this tool. More frequently, they issue stock-option like instruments such as warrant

⁶⁰ “Most [U.S.] venture-capital firms are structured as management companies responsible for managing several pools of capital, each representing a legally separate partnership.” William A. Sahlman, “The structure and governance of venture-capital organizations,” *Journal of Financial Economics* 27 (1990), p. 488. “Over 80% of U.S. venture capital funds are organized as limited partnerships. In these limited partnerships, the venture capitalist serves as the general partner, and the investors as limited partners.” RogersCasey Alternative Investments: Innovative Responses to the Distribution Challenge, Harvard Business School Case No. 9-296-024 (rev. 1998), p. 2.

⁶¹ This is the non-literal translation used by both MITI and JAFCO for “Chuushou Kigyuu Nado Tousei Jigyuu Yuugen Sekinin Kumiai Keiyaku ni kansuru Houritsu.”

⁶² The *Nihon Keizai Shinbun* has reported that MITI now wants to raise the ceiling to 25% and to allow start-ups to grant stock options to outside consultants. “MITI Seeks Eased Stock Option Rules To Help Start-Ups,” *Nikkei Net Interactive*, September 9, 1999.

bonds to investors. The investors then remove the detachable warrants from the bonds and sell them back to the company, which distributes them to managers and employees.⁶³ This complicated procedure allows the managers to avoid tax.

Lack of a Long-Term Exit Strategy

A viable exit strategy is an essential part of the venture capital process. Entrepreneurs seek a payback on their ideas, hard work and assumption of risk. Investors need to be able to foresee a feasible possibility of exiting with a return commensurate with the risk they are taking. While most successful exits in the U.S. VC industry occur through a merger or acquisition of the company by either the original founders or another company, the most profitable form of exit in the United States may disproportionately be an initial public offering.⁶⁴ An IPO provides the firm with immediate capital, an increased public profile, and the ability to tap the public markets in the future. Stock becomes liquid, allowing investors and entrepreneurs to realize gains on their investments.⁶⁵

Conducting an IPO in Japan, however, is an onerous process, at least when compared with the United States. American companies take an average of five years to list on the OTC market compared with over twenty years for their Japanese counterparts—despite an eleven year drop over the last five years in the Japanese average.⁶⁶ Even though it has been much easier to go public using the Japanese OTC markets than the Tokyo Stock Exchange the OTC route has still entailed significant prerequisites to listing. As of 1998 these requirements included pre-tax profits of at least 10 yen per share, at least 1 million shares outstanding prior to the IPO, and paid-in capital of 200 million yen.⁶⁷

Japan's economic slump has resulted in a steady drop in the number of companies newly listed on the Japanese OTC markets from 137 in calendar year 1995 to 60 in 1998 and 20 in the first half of 1999.⁶⁸ By comparison, 31 companies were listed on U.S. Nasdaq dur-

⁶³ See, e.g., Note 9 to JAFCO's Consolidated Financial Statements for FY 1997 in its 1998 Annual Report.

⁶⁴ National Venture Capital Organization, "What is Venture Capital: An Overview"; Josh Lerner, "The Internationalization of Private Equity," HBS Current Research Summaries, available at <http://www.people.hbs.edu/jlerner/IPE.html>.

⁶⁵ Of course, certain shareholders face restrictions regarding how much stock they can sell subsequent to what is commonly referred to as the "exit."

⁶⁶ Makoto Sato, "Nasdaq to give initial issues online fast track," *The Nikkei Weekly*, June 21, 1999; Time Until Going Public: 4 Year Decrease Compared with Last Year" (Koukai made no shoyou kikan: Sakunen 4-nen mijikaku), *Nikkei Kinyuu Shimbun*, August 24, 1999, p. 16.

⁶⁷ Hamao, Packer, and Ritter, "Institutional Affiliation and the Role of Venture Capital," p. 7.

⁶⁸ JAFCO 1998 Annual Report, p. 5.

ing June 1999 alone.⁶⁹ The poor stock performance of OTC- (and TSE-) listed firms in recent years has not helped the situation.⁷⁰

Japanese OTC listing requirements were eased in December 1998 to permit companies losing money to list if they met market capital and other requirements.⁷¹ However, only one IPO to date has involved a firm whose most recently issued financial statements showed a net loss.⁷² It is likely that ventures with little or no profitability that are contemplating an IPO will be hampered for some time by the lack of comparables upon which underwriters and analysts can base their valuations.

Moreover, the nature of Japanese venture capital-backed IPOs to date should raise some concerns in the capital markets. A 1998 study that examined the 456 OTC IPOs conducted from April 1989-December 1995 found that a VC firm affiliated with a securities company was the lead venture capitalist for 99 of the 210 venture capital-backed companies in this group. In over three-quarters of these 99 IPOs, the securities company acted as the lead underwriter. The potential for a conflict of interest is apparent, especially given the fact that managing underwriters generally underwrite some 40-60% of IPO issues themselves in Japan (compared to 25-35% in the U.S.)⁷³

The study found that, unlike other venture capital-backed IPOs, IPOs backed by venture capital firms whose parent was the lead underwriter did not have lower initial returns compared with the market as a whole. The authors of the study concluded that this was consistent with investors insisting on greater underpricing to compensate for the potential conflict of interest. However, the study found that “firms whose lead venture capitalist is affiliated with a securities company perform noticeably worse long-term than other IPOs.” The authors found this consistent with a conflict of interest that was not fully discounted by the market.⁷⁴

⁶⁹ See <http://www.marketdata.nasdaq.com/mr32.html>.

⁷⁰ For example, Japanese companies registered for trading on the OTC market suffered their third straight year of declining profits in FY 1998. “Dip in overall OTC earnings offset by some sharp rises,” *The Nikkei Weekly*, July 12, 1999.

⁷¹ “NASDAQ JAPAN (2): OTC Market Nervous About Competition,” *Nikkei Net Interactive*, July 21, 1999.

⁷² On July 7, 1999, Goodwill Group, an outsourcing services company, that had posted a loss in its fiscal year ended June 1998, went public on the OTC market. However, the company expected to show a profit for its fiscal year ended June 1999. I thank Michael Korver, a principal with the Japanese venture capital firm Global Venture Capital, for this information.

⁷³ Hamao, Packer, and Ritter, “Institutional Affiliation and the Role of Venture Capital,” pp. 12-13 and Table 4. Note that according to JAFCO’s 1998 Annual Report the percentage of IPOs on the Japanese OTC market from 1994 through 1997 that were venture capital-backed ranged from 78% to 90%.

⁷⁴ Hamao, Packer, and Ritter, “Institutional Affiliation and the Role of Venture Capital,” pp. 4-5. In contrast to the United States, Japanese venture capital-backed firms performed the same as firms not backed by VC. The authors found an average return on three year holdings in 355 IPOs from April 1989-December 1994 of -46.1%, compared with -27.2% for nonissuing firms matched on size on industry. Initial returns were “somewhat larger” than the sample (Table 1).

The study also looked at bank-affiliated venture capital firms since such firms are one of the top ten shareholders of pre-IPO companies almost as often as are securities company-affiliated firms.⁷⁵ It found that “venture capital investment through bank subsidiaries appears to have an impact on underpricing distinct from that of direct bank investment.⁷⁶ Bank-related venture capital investment is related to decreased underpricing, but this is not apparent in the case of direct bank investment. Neither form of bank investment affects long-term performance relative to that of non venture capital-backed firms.” Finally, the study found that “whether the bank is a keiretsu bank does not appear to influence the impact that bank-related venture capital or direct bank investment has on either underpricing or long-term performance.”⁷⁷

As for an exit strategy involving a management buyout or sale of the enterprise, Japan’s M&A market is much less developed than that of the United States. However, the upsurge in M&A activity over the last couple of years and the recent interest by foreign and domestic VC firms in Japanese MBOs reflects an evolution in the market. M&A activity in Japan during the first half of 1999 totaled \$38.5 billion dollars, more than the total for all of 1998 and some four times as great as the total for 1996.⁷⁸ A third of VC companies had either been involved in an MBO or were otherwise considering this option according to a recently completed survey by the *Nihon Keizai Shimbun* and The Nikkei Research Institute of Industry and Markets.⁷⁹ *The Nikkei Weekly* reported that JAFCO plans to complete the first MBO in Japan without bank financing. Future cash flows will be used to pay deferred debts arising from the transaction.⁸⁰ Such information is encouraging, but it is important to remember that Japan’s M&A market is still in its infancy.

Cultural Impediments to Entrepreneurship

Financial and legal obstacles and the lack of a promising exit strategy, at least for younger firms, pose significant obstacles to a strong Japanese venture capital industry. Yet cultural factors may present an even greater barrier. Some observers have blamed the decline since the late 1960s in the rate of start-ups, particularly independent companies, on Japan’s affluence and changed social mores. Their conclusion is that “stability-oriented social con-

⁷⁵ However, bank affiliates are less likely to be the lead underwriter and seem more likely to have a long-term focus than are securities affiliates.

⁷⁶ Unlike their U.S. counterparts, Japanese banks may take equity positions in Japanese companies. Hamao, Packer, and Ritter, “Institutional Affiliation and the Role of Venture,” p. 14.

⁷⁷ Hamao, Packer, and Ritter, “Institutional Affiliation and the Role of Venture Capital,” p. 5.

⁷⁸ “Data Shows Rapid Expansion in M&A Business,” (Shihyou ni miru: M&A torihikigaku kyuukakudai), *Nihon Keizai Shimbun*, July 28, 1999. An earlier article put the figure at \$57 billion for the first half of 1999. See “M&A Activity Soars in Japan, But Level Still Low,” *Nikkei Net Interactive*, July 10, 1999.

⁷⁹ “One Out of Three (Venture Capital) Firms Interested in Funding Management Buyouts” (Manejimento Baiouto: Sansha ni issha suishin ya kanshin), *Nikkei Sangyou Shimbun*, June 29, 1999, p. 1.

⁸⁰ “JAFCO to Attempt Buyout Without Bank Financing,” *The Nikkei Weekly*, July 5, 1999.

sciousness, as represented by progression through a single firm rather than founding a firm and developing it, has been one factor in stagnating startup activity’.”⁸¹

For example, the previously discussed legal prohibitions to stock options reflect traditional Japanese attitudes toward seniority in the work place. Pay scales within Japanese companies have been based strictly on seniority. This system rewards employee loyalty by encouraging employees to stay with the same company for their whole career. Yet it also discourages initiative and risk-taking, which are key elements of creating new businesses.

This system is beginning to change at the large Japanese companies as a result of Japan’s long economic slump. And the rigidity of the traditional compensation scheme can actually be seen as a boon to new companies willing to offer financial incentives to individuals willing to risk leaving the big, prestigious Japanese concerns. According to a *Nikkei* study merit-based compensation accounted for more than half of salaries at a quarter of the 304 venture companies surveyed. Seventy percent of the companies intended to institute new salary systems and forty percent of this number said that merit pay would account for more than half of salaries.⁸²

In one sense Japanese culture would seem ideal for venture capital. Relationships are a key component of the U.S. VC industry. Venture capitalists use their relationships with the financial, business and professional communities to find investors, managers and service providers for new firms. Indeed, the well-known Kleiner Perkins firm even speaks of having a “keiretsu.”⁸³

Kleiner Perkins’ use of the term keiretsu reflects its awareness that the VC business involves a much closer set of relationships than a network. Yet despite the high importance of relationships in Japan the system discourages entrepreneurial risk-taking. For many years entrepreneurship has been seen as a departure from the norm, as is evident in one term for entrepreneur, “datsusara.” Literally, this means escape from being a salary man.⁸⁴

Failure is accepted much more in the U.S. than in Japan. Rags to riches to rags (and sometimes back to riches) is part of American lore. Failure is often viewed as providing a valuable learning experience. In fact, some people argue that “the mere act of starting a venture enables entrepreneurs to see other venture opportunities they could neither see nor take advantage of until they had started their initial venture.”⁸⁵ Japanese society, however, takes a much harsher view of failure than does American society.

⁸¹ Whittaker, *Small firms in the Japanese economy*, p. 10, quoting a Japanese writer.

⁸² “Start-ups showing renewed vigor,” *The Nikkei Weekly*, June 7, 1999. Three hundred and four companies responded out of the six hundred companies that were surveyed.

⁸³ Melanie Warner, “Inside the Silicon Valley Money Machine: Kleiner Perkins Funded AOL, Amazon, Sun, and Netscape. Here’s How Tech’s Most Powerful Financiers Work, Plus the Secrets They Don’t Want You to Know,” *Fortune*, October 26, 1998, p. 130.

⁸⁴ “Kigyouka,” a more recent term for entrepreneur, is generally used today.

⁸⁵ See, e.g., Robert Ronstadt, “The Corridor Principle,” *Journal of Business Venturing* 3, p. 31 (1988).

Some Thoughts on the Future of the Japanese Venture Capital Industry

Predictions about the future course of the Japanese venture capital industry are beyond the scope of this paper. However, it is useful to consider the actions of the Japanese Government as well as some current signals from the market. At the same time, we must bear in mind that the cultural factors so important to societal change are a longer-term phenomenon.

Japanese Government Support for New Enterprises

As noted above, the Japanese Government recognizes at least conceptually the role that new ventures can play in an economy. We have seen that from the first days of venture capital in Japan, it has sought to play a constructive role through the establishment of semi-governmental VC firms and the provision of tax breaks and loan guarantees to new ventures. In March 1999 MITI announced that over the next twelve months its Small and Medium Enterprise Agency would jointly establish with the private sector a series of venture capital funds to invest in start-ups, generally businesses less than five years old. The Small Business National Corp. will provide half of the eight billion yen (\$66.67 million) in funding.⁸⁶ Private investors will manage the funds and the government expects them to participate actively in the start-ups by serving on the board and providing advice. And in June it was reported that MITI had set aside 44 billion yen in support for start-up businesses in the current fiscal year, up 44% from FY 1998.⁸⁷

These initiatives may reflect the Government's belief that it should closely direct the economy and therefore raises an immediate concern. Government funding may well constrict investment decisions, exit strategies, and other key decisions on the part of venture capital firms that participate in the new funds. Since the Government will be treated as a limited partner,⁸⁸ fund managers hoping to obtain subsequent infusions of public money might well invest more conservatively than they otherwise would. After all, U.S. VC fund managers are influenced in various ways by their intention or active efforts to raise another fund.⁸⁹

⁸⁶ "Govt, Private Sector To Create 8 Bln Yen Venture Capital Funds," *Nikkei Net Interactive*, March 21, 1999. The program is called the New Enterprise Promotion Investment Business (Shin Jigyou Soushutsu Sokushin Shusshi Jigyou).

⁸⁷ "Entrepreneurship: Govt, Private Sector Boost Support for Start-Ups," *Nikkei Net Interactive*, June 15, 1999.

⁸⁸ The Government contribution is made subject to the condition that private investors must at least match it. If the Government's return exceeds 200% of its investment the fund manager may receive up to 40% of the capital gains (instead of the usual 20%) on subsequent distributions.

⁸⁹ This appears to be a primary driver behind the fact that U.S. funds are increasingly likely to make distributions in stock rather than cash to their investors. This allows them to book a larger return on investment than might be the case if they had to sell all the distributed cash and then distribute the proceeds. See Rogers Casey Alternative Investments: Innovative Responses to the Distribution Challenge.

Advocates of a government role should be aware of the potential difficulties arising out of direct government financial support to new enterprises. While the American venture capital success story should not be understood to mean that there is only one model for a strong venture capital industry, it does provide important lessons.⁹⁰ Most importantly, the growth of the Japanese venture capital industry will depend upon the efficient operation of the market. Investors must be able to make investments where the potential returns are commensurate with the applicable investment risk. Any government intervention that distorts this basic equation may be more harmful than helpful. Observers should monitor whether the government takes real measures to allow the markets to function freely.

Of course, the eight billion yen in funding envisaged by MITI is not much money. Japan's would-be entrepreneurs require a much larger pool of venture capital. Potential distortions created by initiatives such as the one discussed above may be insignificant when placed in the context of larger trends.

Some recent government actions such as the decision to permit limited liability for limited partners are more encouraging. A second reform was a tax provision introduced in fiscal year 1997 that allows individual investors to count investment losses in start-ups against capital gains on stock sales over the next three years. This is called the "angel tax deduction" and the government is considering extending the offset period to five years.⁹¹

Another positive signal is possible legislation to simplify the process of spinning off corporate divisions. Under present law, court-appointed inspectors must value a spin-off's assets before the corporate change is allowed. As a result, spin-offs generally take from three months to a year to occur. However, under a bill recently submitted by the government to the Diet the parent company and its proposed spin-off may instead obtain assessments from auditors or lawyers. This should allow companies to reduce the transaction period to only a month. Nevertheless, under the present proposal Japanese bureaucrats would retain discretionary authority to determine which companies could utilize this expedited procedure.⁹²

The Japanese Government should also take measures to encourage corporate pension funds to invest in VC as well as other private equity funds. Another useful reform would be a lifting of the ban on national university staff being allowed to work for private companies.

⁹⁰ To be sure, U.S. startups often receive funds through local or national government-affiliated vehicles such as the Small Business Investment Company program.

⁹¹ "Wide-ranging incentives needed to encourage Japan's start-ups," *Nikkei Net Interactive*, April 13, 1999; "Japan To Expand Tax Breaks For Retail Investment In Start-Ups," *Nikkei Net Interactive*, September 1, 1999. The government is also considering relaxing other rules related to this tax break. However, earlier this year it did not act on a recommendation from Keidanren, the Federation of Economic Organizations, that the code be revised so that investors can combine such losses with other income in the year of loss and that investors be given a longer period to aggregate them. "Bills raise fears of bureaucratic control," *The Nikkei Weekly*, August 2, 1999.

⁹² "ANALYSIS: Industry Revitalization Bill Goes To Diet," *Nikkei Net Interactive*, July 22, 1999. "Japan Seeks to Speed Up Corporate Spin-Offs," *Nikkei Net Interactive*, July 16, 1999.

Such a measure would provide an incentive for the commercialization of ideas and technology. In the United States, involvement by university-affiliated individuals has been an important component of the success of many new firms. Japanese entrepreneurs also seek tax breaks such as capital gain tax reductions for individual investors. One provision near and dear to the hearts of American entrepreneurs is the tax break for high-tech research and development expenses.

A key test will be the Government's stimulus plan this fall. Finance Minister Kiichi Miyazawa told the *Nihon Keizai Shimbun* in September that the Japanese Diet would focus in October on measures to revitalize small- and medium-sized companies. According to the paper, "The centerpiece will be a tax-code revision to encourage the growth of entrepreneurial start-up companies. The new tax breaks are expected to be implemented from April 2000."⁹³ It is important to remember, however, that government measures to benefit new businesses have been tried in the past,⁹⁴ without great success. Ultimately, a flourishing VC industry requires the emergence of entrepreneurs, an entrepreneurial culture, and venture capitalists capable of assisting new businesses financially and operationally.

Recent Initiatives by Japanese Firms and Exchanges

On the venture capitalist front, recent market signs are encouraging. Over the past few months, several major Japanese VC firms have announced their intention to clear their portfolios of bad equity or debt investments in new businesses (the so-called "living dead") through sales or write-offs. For example, JAFCO took a 15% loss provision against investments that were at least seven years old in firms unlikely to go public over the next year. This cut its FY 1998 earnings by 2.2 billion yen. Japan Asia Investment Company, meanwhile, set aside almost 700 million yen in loss provisions.⁹⁵

Japanese VC firms have also announced efforts to become more directly involved in the IPO process, in part by focusing on start-ups much more than in the past. The *Nihon Keizai Shimbun* reported in June 1999 that Softbank Corporation, the huge Tokyo software and e-commerce firm (see Appendix B), would invest one billion yen in July in a new 10 billion yen fund (\$833 million). The new fund will invest in 20-30 privately owned Japanese firms. Together with two U.S. funds that Softbank also intends to establish, it will focus on Internet-related start-ups.⁹⁶

⁹³ Kaoru Morishita, "Government raises stakes in bid to rev up economy," *The Nikkei Weekly*, September 6, 1999.

⁹⁴ Whittaker mentions two venture-oriented laws, The Temporary Law for Smooth Movement of SMEs [small- and medium-sized enterprises] Into New Business Areas (1993; revised and expanded in 1995) and The Law to Promote Creative SME Activities (1995). Whittaker, *Small firms in the Japanese economy*, p. 210. Government debt guarantees to new businesses are discussed in footnote 52.

⁹⁵ Hisatsu Nagao, "Investors pushing ventures harder to go public," *The Nikkei Weekly*, April 12, 1999.

⁹⁶ The three funds will total over 200 billion yen. "Softbank to Debut 3 Venture Capital Funds, in U.S., Japan," *Nikkei Net Interactive*, June 24, 1999; Norihiko Shirouzu and Jathon Sapsford, "Japan's Softbank Unveils a Package of New Deals," *The Wall Street Journal Interactive Edition*, June 25, 1999; "Foreign media companies join Softbank venture-capital fund," *Nikkei Weekly*, July 5, 1999.

Similarly, Nippon Investment & Finance Company plans to invest more than 90% of its 20 billion yen investment budget for fiscal year 1999 in information technology startups in Japan and overseas.⁹⁷ Matsushita Electric Industrial Co., meanwhile, plans to offer office space in Silicon Valley and professional services expertise to Internet-related start-ups. It intends to take an ownership interest in the companies and to use the technology from the ventures in its operations.⁹⁸

It may soon become easier for promising Japanese companies to list on an exchange. Nasdaq-Japan, an Internet-based securities market that the Nasdaq Stock Market and Softbank are creating, plans to start trading as early as the summer of 2000. Nasdaq-Japan will trade all U.S. Nasdaq-listed issues and will also target high-growth Japanese firms and index funds based on Nasdaq-Japan. The new exchange is aimed primarily at Japanese startups with substantial growth possibilities. If it succeeds, it will help new Japanese ventures gain access to capital. Softbank's Chairman, Masayoshi Son, noted specifically when the venture was announced that "Japanese entrepreneurs have had a very hard time accessing capital markets." The new exchange intends to adopt the registration requirements of U.S. Nasdaq such as quarterly financials, the appointment of outside auditors, and risk disclosure. Prior to beginning operations, however, it must obtain Ministry of Finance approval.⁹⁹

Interestingly, the Tokyo Stock Exchange responded to news that Nasdaq-Japan would be formed by announcing its own stock market for emerging and growth companies. It is unclear whether this will actually be a new exchange or just a relaxation of its listing requirements. Whatever the structure, the TSE will weaken or abolish current listing standards on equity capital, profit, and other financial measures. For example, it has lowered the minimum market capitalization required for listing to 50 billion yen (\$417 million) and will allow companies that have been in business for only one year to list—even if they are

⁹⁷ "Venture Capital Firm To Focus On Info Technology Start-Ups," *Nikkei Net Interactive*, September 15, 1999.

⁹⁸ "Entrepreneurship: Govt, Private Sector Boost Support for Start-Ups," *Nikkei Net Interactive*, June 15, 1999. See also "Nikko Capital to change focus to start-ups," *The Nikkei Weekly*, March 15, 1999; Univ. of Tokyo, CSK Venture Capital to Assist Start-Up Firms, *Nikkei Net Interactive*, June 21, 1999; "Funai Capital to Set Up Technologies Investment Fund," *Nikkei Net Interactive*, June 21, 1999; "Venture Capital Group Selects First Investment," *Nikkei Net Interactive*, June 7, 1999.

⁹⁹ "Softbank Chief Stakes Claim on Internet," *The Nikkei Weekly*, June 21, 1999; Makoto Sato, "Nasdaq to give initial issues online fast track," *The Nikkei Weekly*, June 21, 1999; Bill Spindle, "AWSJ: NASD's Tokyo Market Plan Offers Challenges, Chances," *Dow Jones Newswires*, June 15, 1999; Terzah Ewing and Bill Spindle, "Nasdaq Plans to Launch Stock Market in Japan with Softbank as Its Partner," *The Wall Street Journal Interactive Edition*, June 15, 1999; NASDAQ JAPAN (1): TSE Moving To Create New Stock Market," *Nikkei Net Interactive*, July 21, 1999; "NASDAQ JAPAN (3): Many Issues To Address Before Trade Kicks Off," *Nikkei Net Interactive*, July 21, 1999.

losing money. As will be the case with firms traded on Nasdaq-Japan, TSE-listed firms will be required to issue quarterly financial statements.¹⁰⁰

The Osaka Securities Exchange also announced a new market for start-ups. However, its first listing under this initiative occurred in August 1999 under the existing exchange's new market section ("shinshijou bumon"). Meanwhile, the *Nihon Keizai Shimbun* has reported that regional exchanges in Sapporo, Kyoto and Fukuoka are trying to reverse their poor performance and low trading volume by encouraging the listing of start-ups.¹⁰¹

These are encouraging signs but as always the devil will be in the details. For example, firms with losses or negative equity capital that wish to list on the new TSE market will need to have reasonable plans to turn a profit. This sort of requirement, where the exchange rather than individual investors is making a determination on future profitability, should raise a red flag among observers. By comparison, firms can meet U.S. Nasdaq small cap listing requirements by meeting any one of three thresholds: \$4 million in net tangible assets; \$50 million in market capitalization; or \$750,000 in net income for two of the previous three years.

Japanese entrepreneurs may be less willing than in the past to await domestic change. In August 1999 Internet Initiative Japan became the first Japanese firm to list on the U.S. Nasdaq without first listing on a Japanese market. IJ, which had booked a loss of 1.4 billion yen (\$11.8 million) in fiscal year 1998 on sales of 14.8 billion yen, raised about \$143 million from the offering. The stock surged 36% on the offering date, giving the firm a market capitalization of almost \$1.4 billion.¹⁰²

Foreign Venture Capital Interest in Japan Has Picked Up

Foreign venture capital firms have been showing great interest in Japan. In March of this year Patricof & Co. Ventures Inc., a large U.S. venture capital firm, announced that it would set up an investment joint venture in Japan with Globis Corp, a Japanese firm. The new joint venture is supposed to establish a 15 billion yen (\$125 million) fund aimed at investing in unlisted companies in Japan. It will focus on five sectors, including information/software, publishing/media, and biotechnology. It will also invest in management buyouts. The fund will seek investments from pension funds and institutional investors in Japan, the United States, and Europe. Its five-year target is 100 billion yen (\$833 million) in fund assets.¹⁰³

¹⁰⁰ Newspaper articles have contained contradictory information concerning whether the new TSE initiative will occur this year or in 2000. "OTC Firms Mull Move To TSE's 1st Section," *Nikkei Net Interactive*, August 30, 1999.

¹⁰¹ "SK Japan To List Stock On OSE Start-Up Market," *Nikkei Net Interactive*, July 5, 1999; "TSE To Absorb Hiroshima, Niigata Exchanges," *Nikkei Net Interactive*, July 20, 1999. "New TSE Market To List Shares of Year-Old Firms," *Nikkei Net Interactive*, August 14, 1999.

¹⁰² "Entrepreneurs favor Nasdaq Japan," *The Nikkei Weekly*, August 9, 1999.

¹⁰³ "Major U.S. VC Firm Advancing Into Japan, Will Merge within a Month (and Establish) a 15B Yen Fund" (Bei VC Oute; Nihon Shinshutsu: Gappei Kaisha Getsunai ni 150 oku en kibo fando), *Nihon Keizai*

Also in March the *Nihon Keizai Shimbun* reported that over the next three to five years E.M. Warburg, Pincus & Co. will invest in Japan about 20% of the \$5 billion it has raised worldwide. The article stated that the firm will invest in 10-15 Japanese firms, takes an active role in management, and has a target annual return on investment of about thirty percent.¹⁰⁴ However, apparently Warburg Pincus may invest 20% of its fund outside of the United States, not necessarily all in Japan.¹⁰⁵

In April 1999 NM Rothschild & Sons Ltd. and Mitsui & Co. agreed to set up by June a first fund of up to 15 billion yen targeting Japanese companies. The two partners intend to raise funds from overseas investors and to invest a total of 100 billion yen over three years.¹⁰⁶ The same month Industrial Bank of Japan and 3I group Plc, a British VC firm, established a firm which will focus on management buyouts. The new firm plans to start a 10 billion yen (\$83 million) fund in May for this purpose and hopes to double its size by the end of 1999.¹⁰⁷

In July Rothschild Inc. and Daiwa Securities SB Capital Markets set up a 40 billion yen (\$333 million) fund which will invest primarily in money-losing and failed Japanese firms and regional financial companies. The new fund already has a 12 billion yen commitment from the California Public Employees' Retirement System.¹⁰⁸ Also, Global Venture Capital, an independent Japanese venture capital firm which has completed a \$6 million fund, plans to raise a \$20-30 million second fund this fall targeting Japanese emerging growth companies.

The above-listed funds will total over \$2 billion, a third as much as the present Japanese VC market. Nichimen Corp. and Mitsubishi Corporation also plan to become active in M&A deals through new funds.¹⁰⁹ The market thus is sending some strong signals that investors believe there are substantial opportunities in Japan.

Shimbun, March 5, 1999, p.11; "U.S. Firm Patricof to Form Investment Joint Venture in Japan," *Nikkei Net Interactive*, March 5, 1999. Bill Spindle, "Case Study: Corporate Truant has Lesson in Risk-Taking for Hidebound Japan --- After Harvard, Yoshito Hori Quits Career Track, Turns Night School into Riches --- A Different Marriage Penalty," *The Wall Street Journal*, July 2, 1999.

¹⁰⁴ "U.S. Venture Capital Firm Intends Aggressive Investment in Japan," *Nikkei Net Interactive*, March 22, 1999.

¹⁰⁵ Information provided by Michael Korver. According to the December 3, 1998 *Asian Wall Street Journal*, Credit Lyonnais Securities (Asia) Ltd. estimated that venture capital firms were targeting as much as \$15 billion toward investments in Asia, including Japan. Erik Guyot, "Bankers Force Companies to Look Overseas," *The Asian Wall Street Journal*, December 3, 1998, p. A1.

¹⁰⁶ "Rothschild, Mitsui Plan Fund for Japan Stocks," *The Nikkei Weekly*, April 12, 1999.

¹⁰⁷ "IBJ Partners U.K. Firm in Management Buyout Financing,," *Nikkei Net Interactive*, April 13, 1999.

¹⁰⁸ "Rothschild, Daiwa Capital to Invest in Failing Japan Firms," *Nikkei Net Interactive*, July 7, 1999.

¹⁰⁹ "Nichimen to Mediate M&A Deals, Set Up Fund To Buy Start-Ups," *Nikkei Net Interactive*, July 3, 1999.

These recent initiatives suggest, however, that even if venture capital takes off in Japan, it might well follow the continental European model rather than that of the United States. In Europe, the VC industry is much more concentrated on management buyouts than on IPOs.¹¹⁰ In an economically distressed Japan that is undergoing corporate restructuring management buyouts may well offer the most attractive investment returns. Yet a VC industry that is hospitable to MBOs also will mean greater opportunity than in the past for start-ups.

Conclusion

The American experience shows that a strong venture capital industry can provide a strong boost to an economy. Japan enjoys the broad technical capabilities necessary for a vibrant entrepreneurial sector and the capital required to fund it. Its legal system is not marked by the sort of securities litigation that is of such great concern to the U.S. venture capital industry. Moreover, its economic difficulties mean a greater availability of workers and less resistance to executive recruiting. This could prove to be a boon to the efforts of entrepreneurs and venture capitalists to recruit talented, motivated individuals. In fact, more than a third of start-ups surveyed by the *Nikkei* earlier this year stated that Japan's economic difficulties made it easier for them to hire such individuals.¹¹¹

The Japanese Government should take measures to promote a strong VC industry. Rather than believing that it can play an active role in directing the industry through small capital infusions, however, it should embrace the free market principles that underlie the rationale for the industry in the United States. This means removing obstacles faced by venture capital firms generally and entrepreneurs in particular. While a number of de jure obstacles have been eliminated, the government must also take care to ensure that de facto obstacles do not hamper participants in the venture capital industry.

True understanding of VC-type risk-return relationships on the part of owners and investors entails an educational process in addition to more tangible measures like available financing and the removal of legal barriers. Yet reforms will send a strong message to venture capitalists who are already interested in funding unlisted Japanese companies. They are a prerequisite to success for a Japanese venture capital industry that is healthy over the long term.

A strong VC industry requires that both entrepreneurs and investors be willing to assume substantial risk. Yet despite its rich heritage of small firms Japan lacks the entrepreneurial tradition and culture of the United States. Moreover, as one writer has pointed out, "the entrepreneurship of small firm owners is not of a swashbuckling high-risk-high-return na-

¹¹⁰ Management buyouts are classified as venture capital in Europe, but not in the United States. See European Venture Capital Association website at <http://www.evca.com/venture.html>.

¹¹¹ "Start-Ups See Revenue Rising in FY99: Survey," *Nikkei Net Interactive*, May 24, 1999 (from *The Nikkei Industrial Daily*).

ture. It is more aptly described as craft or productionist entrepreneurship.”¹¹² A cultural shift in Japanese attitudes toward risk-taking and new enterprises is needed.

Patience is not necessarily a virtue in the venture capital world, particularly in Internet-related companies. By the same token venture capitalists 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.

¹¹² Whittaker, Small firms in the Japanese economy, p. 126.

JAFCO¹¹³

JAFCO, Japan's largest and most well-known venture capital firm, is also one of its oldest. Created as the Japan Associated Finance Co., Ltd. in 1973, it was officially renamed "JAFCO Co., Ltd." in 1997. As of March 31, 1999 the company had invested in almost 1,900 venture businesses (1,700 in Japan), 485 of which had gone public (422 in Japan), and was managing 27 Partnership Funds.

From an American VC perspective, JAFCO is an odd-looking entity. For starters, it is a public company (one of only two publicly traded venture capital firms in Japan) with several thousand shareholders. Nomura Securities Co., Ltd. and related Nomura Group entities hold 34% of its stock. JAFCO is listed on Jasdacq, the major Japanese OTC market. It has six branches in Japan and 20 regional VC companies established as joint ventures with regional banks.

JAFCO plays a disproportionate role in the Japanese venture capital industry. Its venture capital investment portfolio is about 180-185 billion yen, slightly over half of which is composed of JAFCO's own money.¹¹⁴ According to the *Nihon Keizai Shimbun*, JAFCO manages almost 23% of the total investment balance reported in the newspaper's study. Twenty two percent of its partnership funds come from overseas investors. While the company made over half of its investments in fiscal year 1998 in the United States, domestic investments still account for over 63% of its investment balance.

JAFCO lost 8.2 billion yen (\$68 million) in the fiscal year ended March 1999 on net sales of 34.4 billion yen (\$287 million), compared with 5 billion yen in net income in fiscal year 1997 on net sales of 36 billion yen. The biggest item on its balance sheet is long-term debt, followed by operational investment securities, which refers to shares and bonds in small and medium-sized companies JAFCO expects to go public. Operational loans are also a big-ticket item. This shows JAFCO's willingness to issue debt to small and medium-sized unlisted companies and affiliated companies. Equity investments represented over 88% of JAFCO's fiscal 1998 investments, up sharply from 60% the previous year.

In its 1999 Annual Report JAFCO's president identifies the company's primary goals as raising its return on equity and its internal rate of return. Both this Report and the 1998

¹¹³ The information in this section comes from the following sources: JAFCO's 1999 and 1998 Annual Reports, which provide information for the fiscal years ended March 31, 1999 and March 31, 1998, respectively (see in particular Notes 2, 4 and 5 to JAFCO's Consolidated Financial Statements); "Jafco Tops OTC Firms For Unrealized Stock Gains," *Nikkei Net Interactive*, June 8, 1999; *Nikkei Net Interactive*, Investor's Watch, available online; "1998 Venture Capital Study," *Nikkei Kinyuu Shimbun* (Japan Financial Daily), June 29, 1999, p. 18.

¹¹⁴ The 1999 Annual Report gives both 185 billion yen and 211 billion yen as the amount managed by JAFCO. The *Nihon Keizai Shimbun* gave the figure as 182 billion yen. One possible explanation for the differences in the JAFCO Annual Report is JAFCO's unrealized gains as 27.9 billion yen.

Report emphasize JAFCO's intention to invest more in early-stage and high-tech companies than in the past. The company has also stopped making commercial loans to financial corporations. Moreover, it announced that as of April 1, 1999 it would tie compensation to performance in order to create incentives for its employees and make them accountable. JAFCO thus is attempting to move toward a more American-style strategy.

JAFCO completed its first domestic MBO during fiscal year 1998. Its 1999 Annual Report states that the management buyout market in Japan offers "excellent potential." The company plans to create a "second JAFCO" over the next decade equivalent in scope to its VC operations. Nevertheless, JAFCO will continue to charge portfolio companies for its "consulting" services, which include professional services, introductions to business partners and computer systems specialists, and human resource consulting.

SOFTBANK CORPORATION¹¹⁵

Softbank Corporation was established as a software distributor in 1981 by Masayoshi Son, a Japanese of Korean descent who was educated in the United States. It is a fast-moving and nontraditional firm. Softbank's aggressive strategy reflects Chairman and Chief Executive Officer Son's age (Son was born in 1957), brashness, and extensive experience in the United States. For example, Yahoo Japan, which Softbank helped found in 1996, went public in less than one year. Pasona Softbank, an online job board created the same year by Softbank, went public in little over two years.

In addition to being Japan's largest distributor of software and computer technology publications, Softbank has invested heavily and with great success for several years in U.S. Internet firms, most notably Yahoo and E*Trade. It holds stakes of more than 25% in both of these firms. Softbank's strategy has been to use some of the capital gains it receives after its portfolio companies firms go public to fund the same businesses in Japan.

Softbank announced earlier this year that it would focus primarily on the Internet. It began selling its holdings in non-Internet companies and has created Internet-based businesses to sell cars, books, toys and other items. Son has declared his intention to "establish an Internet conglomerate" and likened his strategy to the development of the zaibatsus in the early part of the century.

Both Internet entrepreneurs and funds interested in investing in Japanese Internet start-ups can expect to interact with Softbank. One securities analyst in Tokyo estimates that Son owns 70% of Japan's Internet economy. Moreover, in June 1999 Softbank formed a 10 billion yen (\$833 million) venture capital fund focused on Japanese Internet start-ups. It also announced a joint venture with U.S. Nasdaq to set up Nasdaq-Japan in order provide a means for promising Japanese companies to access the capital markets more easily than has been the case to date. The table below lists a small sample of Softbank's more than one hundred investments.

¹¹⁵ The information in this section comes from the following sources: Softbank's home page, available at <http://www.softbank.com>; Neel Chowdhury, "Mr. Japan.com: How Son Captured Japan's Internet Economy," *Fortune*, August 16, 1999, pp. 156-60; Yoshinobu Someya and Kazunari Yokota, "Son follows zaibatsu model in building Softbank into Internet conglomerate," *The Nikkei Weekly*, August 16, 1999; "Changes in Market Cap Rankings Show Shift In Economy," *Nikkei Net Interactive*, September 7, 1999; Sandra Sugawara, "Masayoshi Son Was Among The First To Flout Japan's Business Establishment:: Now He Is One Of The Nation's Wealthiest Businessmen," *The Washington Post*, May 9, 1999, p. H1; "Japan Update," Warburg Dillon Read, July 19, 1999; *Nikkei Net Interactive (Investor's Watch)*; "Market Capitalization of IT, Financial Stocks Rises Sharply," *Nikkei Net Interactive*, August 14, 1999; "Makoto Isomichi, "R&I Analysis: Softbank Corp.: Divestment tactics choking cash flow," *The Nikkei Weekly*, September 6, 1999; "Softbank is bullish on Internet plays," *The Nikkei Weekly*, May 24, 1999; "Foreign media companies join Softbank venture-capital fund," *Nikkei Weekly*, July 5, 1999; "Foreign Companies in Japan," *The Nikkei Weekly*, September 13, 1999.

Softbank Investments

Company	Softbank ownership
<i>E-Loan Japan</i>	60%
<i>GeoCities Japan</i>	60%
<i>InsWeb Japan</i>	60%
<i>Nasdaq Japan</i>	60%
<i>Onsale Japan</i>	60%
<i>E*Trade Japan</i>	58%
<i>Broadcast.com Japan</i>	55%
<i>E-shopping Toys Japan</i>	52%
<i>CarPoint Japan</i>	51%
<i>Yahoo Japan</i>	51%
<i>Cybercash Japan</i>	44%
<i>Morningstar Japan</i>	40%

Source: *Fortune*, August 16, 1999

In August Softbank announced a joint venture with Microsoft and Tokyo Electric Power Company to enter the communications business. Softbank intends the new telecommunications company to serve as a cornerstone of its e-commerce strategy. Instead of using expensive NTT phone lines, the new company will install radio stations on electric poles owned by TEPCO or on the roofs of buildings to connect dedicated terminals to homes. TEPCO's fiber-optic network will allow the joint venture to offer service at less than half of NTT's rates and at more than twenty times the speed of NTT's ISDN system. The new company will start trial services in October 1999 and begin service in the Tokyo metropolitan area next summer. Softbank followed up on this initiative in September when it and Microsoft each agreed to invest \$175 million in Asia Global Crossing, a joint venture with Global Crossing Ltd. to lay an undersea fiber-optic network linking Japan, China, South Korea, and other countries in the region.

Softbank is listed on the first section of the Tokyo Stock Exchange. For the fiscal year ended March 31, 1999, it had consolidated net income of 37.5 billion yen (\$313 million) on revenues of 528 billion yen (\$4.4 billion). Among large Japanese firms listed on the TSE, its stock had the sharpest rise from January through mid-August (345%). Softbank began the year as the 87th largest company traded on the first section of the TSE in terms of market capitalization. By early September it was wedged between Honda and IBJ at number fifteen, with market capitalization of over 4.2 trillion yen.

Despite the rapid rise in Softbank's share price analysts have expressed concerns about the company. Softbank is betting itself on its ability to generate revenue and income from the Internet. Analysts have estimated that its Yahoo Inc. and Yahoo Japan stakes account for sixty to seventy percent of its estimated asset value. They have also been concerned about the company's ability to generate cash flow. Softbank's ongoing divestitures of non-Internet holdings will provide it with immediate cash, but decrease its cash flow from operations sharply.