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Japanese Style Venture Capital in the Twenty-First Century

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Although many organizations have been born in the twentieth century and disappeared without waiting for the coming of the twenty-first, the industry known as "venture capital" will surely step forward into the new century. With some modifications, however, I predict that it will be transformed.

1. Definition of Venture Capital

The term "venture capital" (abbreviated VC) is used in two ways. One is that the capital itself is provided to venture companies. One often hears it said, "Venture capital was invested in Company A." This does not mean secured financing, but only a form of investment. The forms of venture capital investment, therefore, ranges widely from common stock to warranted bonds.

The other use of the term indicates a company or individual which uses the fund. The latter is very popular in Japan. In the case of emphasizing a company, the company name is added after the words "venture capital." In America, venture capital companies have already established an industry, commonly known as "the venture capital industry."

According to a definition of venture capital at the Harvard Business School, "The VC industry provides both capital and other resources to entrepreneurs of any enterprise which is expected to have growth potential and a high rate of investment return."

2. Brief History of Venture Capital

Whether in the East or in the West, it rarely happens that indirect financial institutions such as banks provide capital to such newly established enterprises with no tangible collateral. This is because they use the assets of others of (symbolized by bank deposits); and what is more, they guarantee the safety of those assets.

But at the beginning and just after the establishment of a new venture, a substantial amount of money is necessary. If they had used only their own funds, many of the presently existing enterprises could not have been founded. It can be said from a historical point of view that it was the people who had performed the function of today's VC. They were rich people, such as private bankers and men of real property, and the commission organizations that were entrusted with their assets. They were called merchant bankers in England.

Following World War II, VC developed in the form of independent companies in the United States, crossing over to the Pacific.[1] During the first half of the 1970s, VC was introduced to Japan. A quarter of a century has passed, since then, but Japanese VC has been changing in form as I will explain later. Although the VC boom in Japan began also from the 1980s, continuing over from the 1970s, they were all born as companies associated with financial institutions, established as subsidiaries, due to the support of both human resources and investment funds from their parent companies. Many institutions have continued, therefore, under such arrangements up to the present. The following are approximate characteristics of Japanese venture capital in those early days;

① No funds on hand
② Personnel not from their own staffs, but mostly transferred from the parent institutions.
③ Many borrowers introduced by the parent companies
④ No management assistance to borrowers, in spite of urging them to take advantage of the opportunity to borrow
⑤ Financing company operations in addition

As you can see from the above, VC was not rich in its function at that time, because it had been initiated and carried out in the Japanese traditional custom of following in the other members' footsteps, in other words, "me-too-ism." Japanese VC has, grown up, however, after many twists and turns. As to ①, the investment association was established for the first time in 1982, which brought about a big change in the VC situation. The investment association is an organization for collecting long term capital from special investors and entrusting the investment of collected capital to designated persons. Although "a partner system," corresponding to the Japanese, had already been established in America, Japan organized the associations, using partnership regulations of the civil law because of no suitable law in Japan at that time. This enabled VC to make investment decisions in interest payments and short-term repayments at their own discretion, not being restricted by the capital of the parent companies. This method was adopted by many succeeding VC, and more than 200 investment associations were then born, a result of which was that the balance of their investments amounted to over ¥300 billion. But there was a limit to the enlargement of Japanese VC because of temporary expediency and the unlimited liability system of investors (association members).[2]

Consequently, "the law of contracts on investment associations for medium and small companies" was enacted in1998, which brought forth a "limited liability" of the American type.

Concerning ② on personnel, talented persons suitable to VC, at last, have grown up even in Japan, as a quarter century has passed. As for their occupations, they are mostly middle class managers, and positions of top managers are still occupied by executives transferred from the parent companies. Another problem is how to transfer the rich store of venture capitalist knowledge to the younger generation. Although there exists a criterion of finding companies for investment in such fields as finance, accounting, organization, and so on, the overall judgement of finding a company with growth potential has been left to the investor. Actually, some people have acquired such sense of judgement through experience, but the problem is how their sense of judgement has been succeeded in the organization. This would be a point at issue later on.

As to ③ of the borrowers, the fact is that most of them have been introduced by the parent company's group, which has, as a matter of course, limitations. The method of looking for investors by a roller strategy was, at first, tried by some VCs, who discovered the problem of cost-performance. Japanese VCs will adopt the same style as that of the American in that VCs have only to examine the items of investment offered from the standpoint of people who want to invest. In order to transfer to the American style, borrowers are required to have presentation competence, which has been recently realized by the appearance of young executives who wish to make a public offering.

④ Management support ought to be a principal activity of VC in the twenty-first century. In order to give management advice, the development of talented persons and manpower from the side of VC is needed, as indicated in ②. It will not do to gobble up at the companies which are about to go public and rake off the founders' profits. The value of the enterprises concerned should be enhanced by the VC's participation in management. [3)]

⑤ VC has a serious problem with financing activities. Since many VCs were characterized by a detachment from financial institutions from the first, they were forced to engage in financing activities unrelated to investment. At the time of the collapse of the bubble economy, most individual financing activities turned into bad debts, so that some VCs were forced to shorten their lives occasionally. Owing to the resultant reconsideration, as will be indicated later, VC has been forced to reduce financing activities drastically at present.

3. Fundamental Forms of VC Activities

VC is not a permanent investor. VC collects invested capital and then reinvests it. Idealistically, VC earns profits for itself through this cycle, and simultaneously performs a social duty of supporting growing companies. The typical processes of VC activities are the following :

① VC investigates medium and small but not yet publicly held growth companies, mainly systematically independent companies, from the point of view of the presentation, and from the business philosophy of individuals who haven't set up a company as yet.
② VC evaluates the business plans of either the company or of the individual and then gives advice.
③ After negotiation on details of the investment, VC contributes business capital mainly in the form of an investment (shares, convertible bonds, corporate bonds with stock purchase rights, etc.)
④ For the growth of borrowing companies (increase in the value of the company), VC supports their own management.
⑤ After the borrower has publicly offered its shares, (including privately held shares), VC floats (sells) the purchased shares, etc., to obtain capital gains.

Regarding ⑤, it is orthodox to open the stock of the borrowing company (IPO), but there have been many cases of merger and acquisition (M&A) in America. As in recent cases of Mothers or Nasdaq Japan, the exit of opening the stock offerings has been expanding. Because of fixed rules and standards of the stock market, however, it cannot have been attractive to investors in the long run. This is a conclusion of Japanese VC's of long experiences. The forthcoming stock market, including over-the-counter share market (like the so-called Jasdaq) is worth following closely.

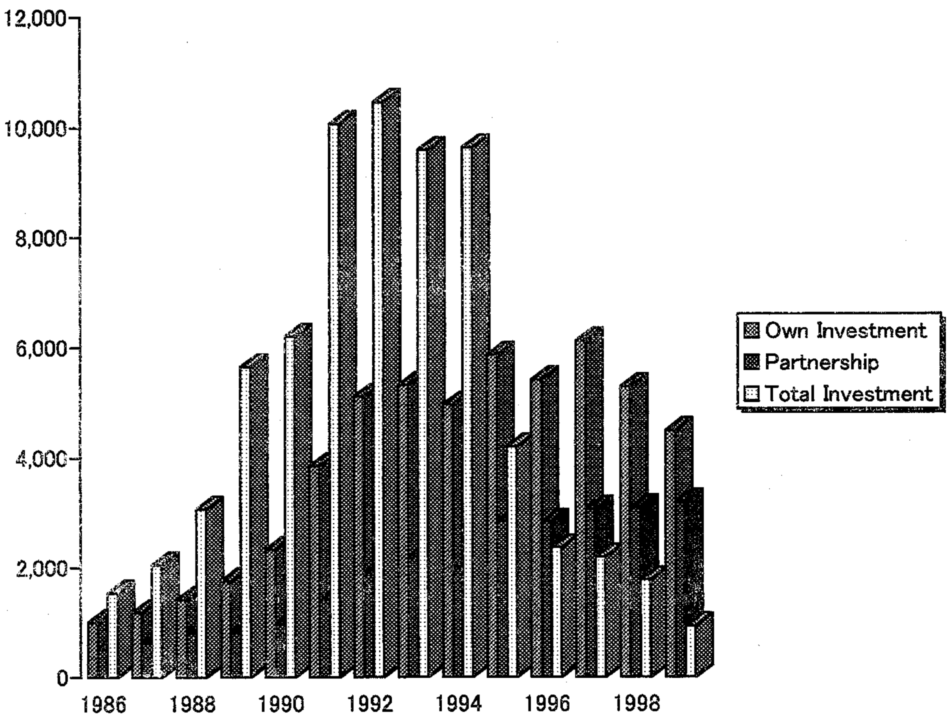
4. Present Situation of the Japanese VC

In the first half of the 1970s, the so-called first eight companies, including Kyoto Enterprise Development (KED) a pioneer of VC, were established for the first time. Subsequently, as many as or more than 60 VCs were established in the 1980s, especially between 1982 and 1985, owing to city and regional banks. They were mostly joint ventures with Jafco.

An accurate number of VC is, not available, however, because there was nothing to correspond with the VC industry in Japan, and they were free to name the company VC. The investigation of VC is now underway by three: Venture Enterprise Center (VEC), the Small and Medium Enterprise Agency, and Nihon Keizai Shimbun, respectively. Approximately 100 companies will respond to the questionnaires of VEC. This will give us the approximate number of VC which are now active in Japan.

In order to classify VC companies, they have been categorized by their parent or security companies and banks to date, but they have begun to show a trend for independence from their parent organizations. Three small and medium enterprise investment have companies in Tokyo, Osaka, and Nagoya, and have achieved a remarkable development on their own.

Figure1. Transition of Loans and Investments Balance



Source : Venture Enterprise Center

Figure 1 shows the balance of investment and lending of VC in Japan (according to VEC survey). Autonomous (or independent) investment*1 means the amount of investment according to self-accounting of VC, while partnership*2 investment, the amount of investment according to the investment partnership I have described earlier. As shown clearly by the figure, financing had been increasing very rapidly up to 1994, but this was mostly financing secured by real estate and unrelated to the main business of VC, which caused very serious losses at the collapse of the bubble economy. Immediately after the debacle of the bubble economy, financing was reorganized, and got closer to its original form of VC. Though the balance in March at the end of fiscal year of 2000 has not been reported yet, the following facts can be clearly observed;

① Many funds have been established on a large scale.

② Due to rising share prices (particularly in the over-the-counter market), VC earned capital gains, which made independent investment very active.

③ A large increase in investment is predicted by the remarkable amount of capital investment (estimated at ¥50 billion), due to the appearance of new powers, such as the Soft Bank Group in the VC industry. (Results of a survey of the Nihon Keizai Shimbun were announced while the author was writing this report. According to survey, new investment from 108 companies amounted to as much as ¥268.3 billion in 1999, which was 2.2 times as much as that of the previous year.)

5. Noteworthy Points

The following are recent noteworthy points on VC apart from the description of prospects.

① Due to the prolonged economic depression, especially the aggravation of employment circumstances, creativity in the venture industry is strongly expected.[4)]

② New business openings remain long depressed. The rate of growth in productivity has also slowed down, an unfavorable comparison with OECD countries'. This is the reason for promoting new business openings and of combining improvement in production with the new venture industry movement.

③ As a result of ① and ②, venture industry support has become an urgent national policy since 1995, and the following supporting laws have been enacted :

① 1995 Small and Medium Enterprise Activity Promotion Law
② 1997 Introduction of the Angel Tax System
③ 1998 Investment Business Limited Liability Association Law
④ 1998 University Technology Transfer Promotion Law
⑤ 1998 New Business Establishing Promotion Law
⑥ 1999 Small and Medium Enterprise Management Reform Law
⑦ 1999 Industrial Vitality Restoration Law
⑧ 1999 Revision of the Fundamental Law of Small and Medium Enterprises
⑨ 2000 Industrial Technology Reinforcement Law
⑩ 2000 Small and Medium Enterprise Supporting Law

④ As a result of new participation, VCs have been diversified. The newly participating companies are financial agencies connected with government, insurance companies, trading companies, and successful companies in venture capital, as well as security companies and banks.

6. Prospectus

The forthcoming noteworthy point is that the advent of such venture enterprises can correspond to both the diversification of VC (increase in number) and to the legal provision of related supporting laws as well. Venture enterprises fail to increase in number for the simple reason that they have enjoyed an establishment boom throughout Japan since 1995 and show a tendency to stop decreasing in number. The question at issue is how to fill the gap between the establishment movement and a supporting method for venture enterprise. One answer may be (as often insisted, upon) that Japanese VC need to develop an office of coordinator to link support methods with venture enterprise.

Improvement in the capability of VC itself is necessary in order to initialize pending investments. If investment in venture capital is initialized with no improvement in VC capability because of the intensified keen competition, quite a dangerous situation is likely to emerge.

There would be many potential angels (rich individual investors) whose money may be accounted as a financial source for VC. According to a survey by MITI in Hokkaido, about 50% of high income earners take a positive attitude towards venture enterprise investment in some form or other. [5] Since 1999, MITI has published VC performance benchmarks for information to the investors', [6] a very effective criterion by which the investors may judge.

Generally speaking, these 25 years should be called the preparatory period for Japanese VC. Future development of VC activity suitable for Japan is highly anticipated.

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Notes

* 1 Investment from venture capital firms, operating on their own fund.

* 2 Investment from a group of firms under partnership arrangement.

1. The first VC in the world is said to have been the American Research Development (ARD), founded at Boston in 1946.

2. The followings are characteristic of voluntary associations under the civil law.

   [1] Association assets are the common property of all members in the association.

   [2] Obligation of the association are divided among all association members and unlimited liability for the direct creditor.

   [3] Because it is a mutual organization undertaking joint projects, the association is legally abstract, and therefore, incorporation is never approved.

   [4] Under contract, the association should designate the executive to perform duties and take legal action on behalf of all members.

[5] Taxes are laid not on the association itself, but on members of the association directly.

3. This kind of VC activity is called "value added." The enterprise requires integrated strength in management for this purpose, because of the additional time required for realization. For additional information, see Hata Nobuyuki, Higashide, Hironori: State of Venture Finance and the Role of VC, edited by Matsuda Shuichi: Management and Support of Venture Enterprises (New Edition), Tokyo Keizai Inc., 2000.
4. According to a survey conducted by the Ministry of International Trade and Industry at 102 companies whose shares were traded over the counter in 1997, the employment rate increased by 25.3% from 1995 to 1998. It is obvious that publicly traded companies contributed to employment opportunities because the employment rate for all businesses in Japan increased by only 2 %, during the same period.
5. Survey of Consciousness for Support on Venture Enterprises during the Wealthy Class in Hokkaido, MITI Hokkaido, March 2000.
6. Bench marks for 1999 were also announced (Refer to the source document list). As to 1998, see Nakajima, Asai: *Characteristics of the Performance of Venture Capital and Funds in Japan* and the April 2000 edition of Securities Analyst Journal.

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