Brief summary of Japanese venture capital industry

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History

The history of Japanese venture capital industry traces back to the early 1970s when rules for initial public offerings on the Over-The-Counter (OTC) market (later renamed JASDAQ OTC market) were liberalized. The new regulatory changes motivated a number of small firms to considering an OTC listing and led many brokerage firms to setting up venture capital subsidiaries to support this new movement. This resulted in the development of a Japanese venture capital industry. To date Japan has experienced several venture business booms: in the early 1970s, in the middle of 1980s, and during the bubble economy years when funds began pouring in volume. Corporate investors spent 20.5 billion yen, and banks invested 15.8 billion yen in venture businesses. When the bubble burst, funding declined sharply through the 1990s and did not pick up again until 1998. By then a new generation of venture capital firms, epitomized by Softbank and Hikari Tsushin emerged. Both firms saw a great chance in Internet and telecommunications, and aggressively invested in related venture businesses. Attracted by this new momentum US groups such as Whiteney & Company, Broadview and Warburg Pincus, H&Q Asia launched operations in Japan as well. Mighty Japanese trading companies also set up their own venture capital units.

Responding to this development new stock exchanges were established: Mothers (Market of the High-Growth and Emerging Stocks) in 1999 and NASDAQ Japan in 2000. They aimed at making it easier and faster for emerging companies to conduct initial public offerings. JASDAQ OTC also relaxed its more rigid initial listing requirements.

As the new economy boom deflated and the economy started to slow down worldwide towards the end of 2000, the Japanese venture capital industry did not remain unaffected, either. A recently published survey by Ministry of Economy, Trade and Industry (METI) well reflects the latest trend, which will be later discussed more in detail.

Characteristics

There are over 200 venture capital firms in Japan. Few of them are independent. The majority of them are subsidiaries or affiliated companies of the financial institutions such as banks, securities firms and insurance companies. In many cases, the board members as well as the employees are engaged in venture capital as part of their career rotation and thus have limited opportunity to acquire experience as venture capitalists. Coming from financial industry, a very small number of them have scientific or technological backgrounds. As a result most of the venture capital firms often depend on the judgment of others. According to observers, such dependent investment strategy may have accelerated the boom and bust of the IT bubble and discouraged investment over the long term. Moreover, lack of scientific or technical background makes it especially difficult for those venture capitalists to identify and evaluate seed stage technology. This could explain why Japanese venture capitals mainly focus on middle and later stage ventures.

Traditionally, Japanese venture capital firms prefer loan financing to equity taking. Approximately 70% of venture capital financing is in the form of loan rather than equity investment. According to a survey by Nikkei Shimbun, a Japanese economic daily, bank-affiliated venture capital companies are especially reluctant to tolerate risk and foster start-ups, so they tend to provide only a limited amount of funds to a large number of firms to be in line with their parent banks' operations. In the fiscal year 2000 they invested less than 40% of their funds in firms younger than 5 years, compared with independent investors who contributed about 70%. A significant characteristic of Japanese venture capital firms is that they take small positions in a venture business and invite other venture capital firms to make similar investments, which is called ‘convoy style’. By doing so, risks, - including those for the responsible investment manager’s reputation, can be limited. However, it may also result in smaller returns in case of successful exits since the returns are shared with all other investing venture capital firms.

FY 2001 survey on venture capital investment status by METI

The survey covers the investment activities from 1. October 2000 to 30. September 2001. The contribution made by venture capital firms increased by 14% to 1.04 trillion yen compared to a year earlier. New investments made during the same period amounted to the record-breaking 282.5 billion yen, resulting in an increase of 22%. However, the new investments increased merely 1% if only those companies, which responded to the previous year’s survey, are taken into account (it means that not all venture capital firms responded to the survey are identical). Investments between April and September 2001 were down 43% from those in preceding 6 months. This clearly indicates that venture capital firms became increasingly cautious with their investments.

IT-related businesses accounted for 53% (down from 60% from the previous year). Among them the investment in computer-related field significantly decreased from 25% to 15%.

Concerning future investment focus a number of respondents mentioned biotechnology (58%) and medical care (38%) as priority fields. To date the investments in these businesses have been rather moderate.

50% of new investments were done in the Tokyo area, growing from 36% one year earlier. New investments abroad decreased from 29% of total new investment to 12%. Investment focus shifted from the Asia-Pacific region (24% to 4%) to the North American region (5% to 11%).

Investors in newly raised funds are banks including saving unions 33%, corporations 26%, insurance companies 14% and individuals 8%. Interestingly, unlike in the US where pension funds account for the largest portion among investors (38% in 1998) Japanese pension funds represent only 2% which is less than that of overseas' investors (3%).

Recent development

Five major venture capital firms (Jafco Co., NIF Ventures Co., SMBC Capital Co., Orix Capital Corp., and Japan Asia Investment) pulled back on their investments since the beginning of FY 2001. Their investments total from April to September plummeted 43% from a year earlier to 31.1 billion yen. The number of investment projects plunged, too. These big five venture capital firms accounted for 30% of total investments made (as of July 2001), which is thought to be considerably less as of the end of 2001 (Nihon Keizai Shimbun). Venture capital firms chose fewer investment targets but increased their spending per company. One major factor behind this change seems to be the insufficient attractiveness of Japanese start-up companies, Nihon Keizai Shimbun reported. Some foreign venture capital companies were set to close their Japanese units or canceled plans to make investments.

At first glance these developments do not show any encouraging future. However, the environment surrounding the venture capital industry has been, in fact, improving recently. Having experienced the long and deteriorating economic slowdown in 90's, the Japanese government has increasingly come to believe that developing and promoting venture business is the key to vitalize the ailing economy, regain strengths and create new jobs. In 1997 the Government introduced tax incentives in favor of 'angels'. This system allows recognized angels to pay tax on just a quarter of the capital gain realized from shares in company concerned, once it is listed. In 1998 the limited partnership act was introduced, giving the venture capital funds more flexibility for the choice of the entity. At the end of 2001 the Diet (Japanese parliament) approved a revision of the Commercial Code that should remove restrictions on stock options and allow firms to issue various type of stocks. It also permits companies to issue stock with veto rights on specific matters, aiming to boost investment by venture capital firms and others involved with start-up companies. The amendment is mainly designed to help launch and develop start-up businesses by enabling entrepreneurs to more easily raise funds. The amendment was enforced in April 2002.

On the investors side there have been also some new movements: A nationwide federation of start-up business supporters known as the Federation of Angels Forum in Japan was formed in January 2002 to better help fledgling companies develop their businesses. The group aims to serve as a forum for start-up companies to share know-how and expertise as well as offering representatives of new companies a chance to interact with venture capitalists and investors from across the country. Some leading venture capital firms such as NIF Ventures or Jafco have set about establishing an association of venture capital industry, 'Nippon Venture Capital Kyokai' (Japan Venture Capital Association) planned to be launched by fall of this year. Those organizations will contribute to further improvement of the venture business environment for start-up firms as well as investors.

New trend and uncultivated opportunity

As the METI survey suggested, venture capital firms show keen interest in biotech ventures. The number of Japanese firms investing in this field is indeed increasing rapidly. Since 1999, the investments have accumulated a total of more than 50 billion yen. Experts predict that some 20 billion yen will be invested in Japanese biotech ventures over the next three years. A series of remarkable investments have been done recently. BioFrontier Partners Inc, an independent venture capital company, set up a fund targeting biotech ventures at the end of 2001. Another independent VC, Japan Asia Investment Co., launched a 1.5 billion yen venture capital fund last year. It has already invested in 14 biotech ventures. Softbank Investment is said to plan investments in biotech-related firms. The prospects of biotech ventures have attracted not only venture capital firms but also other companies such as general trading companies. Itochu Corp. is expected to launch a new fund worth about 18 billion yen in the summer 2002. The fund focuses on investments in bio-related start-ups worldwide. Currently there are 10 Japanese firms with funds or investment frameworks specializing in domestic and foreign biotech ventures and they plan to expand their investment activities worldwide.

The METI survey showed that Japanese pension funds represent only 2% of investors in venture capital. According to another survey on pension funds conducted by Small and Medium Enterprise Agency in 2000, merely 1.6% of them already invested in venture capital. Almost 15% had neither invested nor had the intention to in the near future. About 70% never considered venture investments at all. Main reasons for their negative attitude towards venture investments lie among others in: 1) insufficient disclosure of venture firms and venture capital funds, 2) too high risks of this asset class, 3) difficulty to evaluate the price of the asset, 4) unclear methods and lack of benchmark for evaluating the fair value of venture firms and funds and 5) lack of asset management advisors with enough knowledge.

Pension funds along with mutual funds and life insurance firms usually have the capacity to diversify investments and to invest on a longer time horizon. They may act as a financing channel connecting the vast amount of household financial assets and venture firms, which has not, however, worked well so far in Japan. If the Japanese venture capital industry succeeds in dealing with those issues pointed out by the pension funds, it will gain vast uncultivated land of opportunities for itself. This may, in the long run, also help create new jobs, boost the Japanese economy and regain its competitiveness in a global context.

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