

Utilization of Direct Investment by Small and Medium Enterprises in Japan

– Focusing on Venture Investment from SMRJ –

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Fundraising by small and medium enterprises in Japan depends principally on “Indirect Financing” such as borrowing from banks. During 1990s institutional arrangement was made to facilitate investment in funds, an effective means of fundraising by small and medium enterprises through “Direct Investment” whereby a number of venture funds were actively created. Their investment in fact has contributed importantly to the growth of many venture businesses.

The outbreak of the crisis in global stock markets caused by subprime lending and the bankruptcy of Lehman Brothers in the fall of 2008 seriously affected venture financing in Japan too, followed by stalemate in fund formation, stagnant new investment, failure of invested enterprises... and collapse of bankruptcy of post-IPO firms and fund management companies. Under such circumstances, however, there appear steady signs of new opportunities for venture financing.

1. Fundraising by small and medium enterprises and direct investment

(1) Fundraising by small and medium enterprises where indirect financing prevails

Fundraising by Japanese small and medium enterprises depends principally on indirect financing while the share of direct financing is quite limited. It is still considerably more difficult for small businesses to have access to the market for

funding. Among Japanese corporations, 99% are small and medium enterprises with less than 300 employees, of which 86% are small businesses with less than 20 workers, more than half of them being very small establishments with 4 employees or less¹⁾. Shikano (2008)²⁾ uses CRD database to show the profile of Japanese small and medium enterprises, which highlights low equity ratio and high dependence on borrowing as one of the characteristics of their financial conditions. In the background of such fragile financial structure, there exist favorable policies taken by the central and local governments and financial institutions though access to the capital market remains quite difficult.

Generally speaking, fundraising through direct investment by funds is an effective method for collateral-lacking small businesses to obtain initial funding or to resolve undercapitalization. Venture funds, in particular, are expected to play the leading role to promote rapid growth of companies and emergence of new industries. The fact remains, however, that lending by financial institutions has been well developed accompanied with financial policies in favor of small and medium enterprises in Japan so that “necessary funds can be adequately obtained from financial institutions.”³⁾ Though it may be said from the viewpoint of small and medium enterprises that Japan has not grown out of the old ways of “protect-the-weak” policies, efforts have been made to diversify funding by small and medium enterprises since the latter half of 1990s.

(2) Revision of Small and Medium Enterprise Basic Law and move toward capital market

Since the revision of Small and Medium Enterprise Basic Law (1999), Japan’s public policy toward small and medium enterprises has been changed to emphasize entrepreneur’s self-help endeavor by extending start-up assistance to entrepreneurs with “ability and commitment” and support for management innovation, and by

1) Ministry of Internal Affairs and Communications, 2004, Statistical Research on Establishments and Enterprises

2) Yoshiaki Shikano, 2008, “Small and Medium Enterprises in Japan, Reality of Management and Finance as Observed in CRD Data”, Toyo Keizai, Inc.

3) White Paper on Small and Medium Enterprises 2009, p. 150

providing safety net for small and medium enterprises in general. It depends on the following reasons; In order to revitalize the Japanese economy developed, it is important the presence of diverse and vibrant small businesses, so the government must help small businesses help themselves seriously. At the same time, for fundraising by small and medium enterprises in the context of transforming the core system of financing in Japan from banking to capital market through a “Financial Big Bang” reform, “Law for Limited Partnership for Venture Capital Investment of Small and Medium Enterprises” (Law for Limited Partnership, November 1998), and “Law for Facilitating Creation of New Business”⁴⁾ (February 1999) were put into effect. Thus legal structure for fund business was developed and investment activities by the Organization for Small & Medium Enterprises and Regional Innovation, JAPAN (hereinafter referred to as SMRJ) began investment in venture capitals. Henceforth, as new entry into fund business has been accelerated, there has taken place rapid increase of venture funds both in terms of number of funds and aggregate amount invested with a result that the way to access to capital market by small and medium and venture enterprises has been widely expanded. Each Securities Exchange set up sections for newly traded stocks while a number of enterprises successfully listed their share in the market.

2. Investment in funds by the Organization for Small & Medium Enterprises and Regional Innovation, JAPAN; SMRJ – focusing on venture funds⁵⁾

(1) Fund scheme of SMRJ

Currently, the official investment activity to small and medium enterprises is principally carried out by SMRJ. This is partly because many of other agencies to

4) The law was abolished in 2005 and unified into the new “Law for Promotion of New Business Activities by Small and Medium Enterprises.”

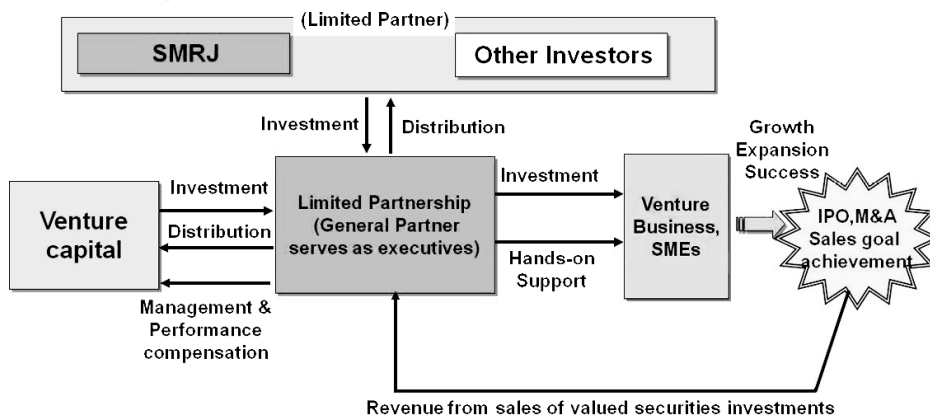
5) In financing from the public section of VE of Japan, the development bank of Japan is also bearing the big role. It is lending promising VE positively. It attracts attention as one of the “un-traditional” financial method, because use of direct investment of small and medium-sized enterprises is very difficult now.

assist small and medium enterprises do not have investment functions while the primary objective of fund investment activity by public sector such as SMRJ is to promote capital market for small and medium enterprises to facilitate their fundraising from such market.

Figure 1 shows the fund flow of SMRJ, which participates in “Investment Fund” (Limited Partnership for Investment Activities) as “Limited Partner” (LP) and is

(Figure 1) Fund Scheme of SMRJ

【Basic scheme for operations】



(Source: The website of SMRJ)
<http://www.smrj.go.jp/fund/gaiyo/026045.html>

(Figure 2) Fund Investment Activities of SMRJ/Records of Investment Commitments for Types of Funds

(Unit : 100million yen data as of end of March, 2009)

Name	No. of funds	Committed Capital of SMRJ	Sum of Investment	No. of firms	No. of IPO
Venture Fund	83	132,468	52,082	90,406	92
Keep it up! SME Fund	25	46,145	22,665	18,272	1
Keep it up! SME Fund (Business Succession Fund)	5	23,000	11,400	5,405	0
The Regional SME Turnaround Fund	16	49,120	23,280	25,652	0
Regional SME Support Fund	3	3,965	1,950	961	0
Total	132	254,698	111,377	140,696	93

(Source: Documents by SMRJ)

not directly engaged in fund management. Its management is carried out by an investment management company as “General Partner” (GP). SMRJ participates in the establishment of the fund and invests in it up to 50% thereby exerts governing influence over the administration of the fund. Through such scheme, it develops investment activities in small and medium enterprise funds as official funding resource (**Figure 2**).

(2) Venture funds of SMRJ

Among fund activities of SMRJ, we will see the venture funds, effective means for fundraising by small businesses. Venture fund activities of SMRJ amount to 83 funds where investments have been made with aggregate fund amount of 132.4 billion yen (of which 52.0 billion yen was invested by the organization). The number of recipient enterprises reached 2,045 in total. The venture funds of SMRJ characterized by investment in venture businesses with less than 7 year after creation and are in the early stage of growth. General partners that manage the funds of the organization are of such diversity as governmental venture capitals including Big 3 investment companies, venture capitals affiliated to city banks, credit unions, and local banks, independent venture capitals without affiliated major company, those affiliated to industrial corporations or trading companies. As a result each of the organization-involved funds has variety of distinct features reflecting the characteristics of the general partner, although they share common factors in the basic fund structure (early stage investment, hands-on assistance).

Furthermore, the funds of SMRJ are broken down by investment objectives into different categories; due to their characteristics, it has been pointed out that venture funds tend to have the following problems:

- 1) Enterprises they invest in tend to be located in big cities causing shortage of investment in regional areas.

In other words, investments tend to be concentrate in companies located near urban areas in the proximity of the markets. Funds themselves would select enterprises near their own location as they need to assess growth potentiality and

keep an eye on their investment. Thus emerging businesses in local communities inevitably have less opportunity to obtain information on the funds and to receive investment from them.

2) Shortage of money available for areas where large scale, long-term investment is needed.

Some sectors, for example, cutting-edge high-tech and bio-technology industries, are critically important for the future development of the nation. They require phenomenal amount of financial resources as well as considerable time to realize profitability through commercialization of innovative technology or new pharmaceutical products. As they are in need of support from the early, so-called “seed” stage, the funds need to have precise knowledge and assessment ability as well as robustness to undertake large monetary investment and long-term commitment.

To solve such problems that venture funds face, the venture funds of SMRJ establish and invest in funds to invest in businesses in regional areas and cutting-edge technology sectors in need of adequate funding. **Figure 3** shows the relations between general partners that manage funds and types of investment objectives. It indicates that, in terms of the number of cases, balanced investment composition is achieved including regional cooperation, while public venture financing are regarded to be more involved in objective-oriented funds for investment in industrial/academic alliance, semi-conductors, and bio-technology in terms of amount outstanding of investment already made. As for regional cooperation, it shows that depending on the types of funds, different general partners will play the role of lead investors; for example those affiliated to local banks or credit associations lead local cooperation investment or those affiliated to security firms for industrial/academic alliance projects. It is based on the aim which raises the effect of investment to this. Moreover, the role which the independent system GP plays also has a big thing. In general, this type of venture capital is that a flexible mind and a clear sense of purpose. To promotes it; that is to discover and develop lead to the next generation of venture enterprises.

(Figure 3) Relations between Types of Funds and Objective of Investment Syndicates

Types of Funds	Types of GP	Number of funds	Number of investment companies	accumulative investment	Average investment per fund	Average investment per company	
General	Commercial banks	1	112	2,442,053,800	2,442,053,800	21,804,052	
	Corporations	1	3	105,750,000	105,750,000	35,250,000	
	Security firms	4	171	5,860,388,908	1,465,097,227	34,271,280	
	public corporations	7	308	13,537,826,746	1,933,975,249	43,953,983	
	insurance companies	2	37	3,877,035,000	1,938,517,500	104,784,730	
	Independent	8	267	8,223,987,398	1,027,998,425	30,801,451	
	subtotal	23	898	34,047,041,852	1,480,306,167	37,914,301	
	Others	3	63	1,688,574,000	562,858,000	26,802,762	
	Security firms	1	5	189,900,000	189,900,000	37,980,000	
	public corporations	1	15	522,984,000	522,984,000	34,865,600	
for regional cooperation	local banks/credit associations	7	128	2,624,321,400	374,903,057	20,502,511	
	Independent	13	225	8,308,851,854	639,142,450	36,928,230	
	subtotal	25	436	13,334,631,254	533,385,250	30,584,017	
	Others	1	32	4,616,106,713	4,616,106,713	144,253,335	
	Security firms	3	54	4,152,045,736	1,384,015,245	76,889,736	
	public corporations	1	25	795,224,000	795,224,000	31,808,960	
	insurance companies	2	43	2,442,778,000	1,221,389,000	56,808,791	
	Independent	5	116	4,500,820,000	900,164,000	38,800,172	
	subtotal	12	270	16,506,974,449	1,375,581,204	61,136,942	
	Corporations	6	116	7,014,097,638	1,169,016,273	60,466,359	
for investment in industrial/academic alliance	Business companies	1	29	1,731,173,333	1,731,173,333	59,695,632	
	Security firms	2	14	471,290,000	235,645,000	33,663,571	
	insurance companies	1	23	1,727,786,050	1,727,786,050	75,121,133	
	Independent	13	206	11,845,757,838	911,212,141	57,503,679	
	subtotal	23	388	22,790,104,859	990,874,124	58,737,384	
	Others	83	1992	86,678,752,414	1,044,322,318	43,513,430	
	Objective-oriented	Commercial banks	1	112	2,442,053,800	2,442,053,800	21,804,052
		Corporations	1	3	105,750,000	105,750,000	35,250,000
		Security firms	4	171	5,860,388,908	1,465,097,227	34,271,280
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(Source compiled by the author from the data disclosed by SMRJ.)

(3) The current situation and the problems in venture finance market

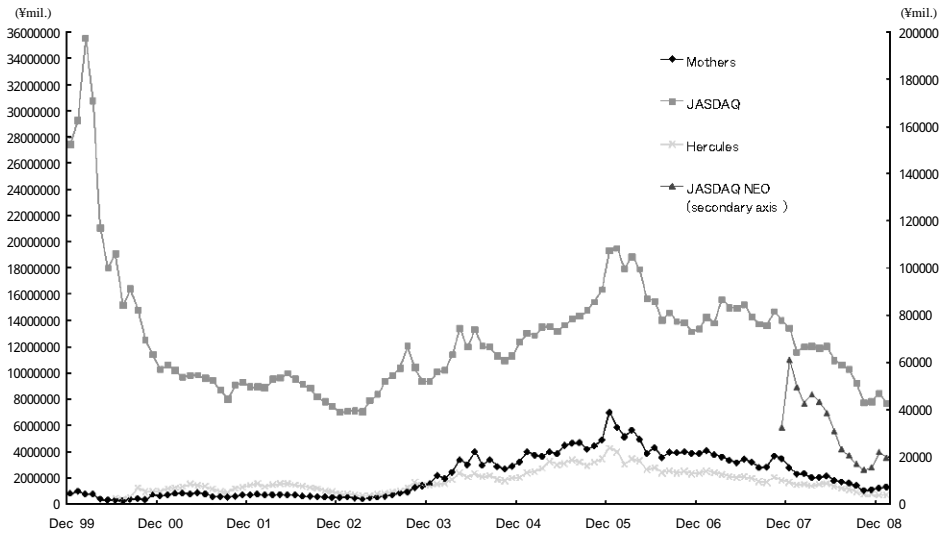
The venture finance market in Japan became lively approximately since around 2000 and has continued to register robust growth after the collapse of so-called “dot-com bubble.” By loosening up the criteria for listing, newly-established markets allowed birth of a large number of listed companies, while exposing various problems. It was consecutively revealed that a number of companies committed breach of compliance such as false statement and accounting fraud as well as relations with anti-social groups. Thus there have been many cases of expulsion from the market. Symbolic among them was the case of livedoor Co., Ltd. prompting investors’ loss of confidence in newly-established markets. Moreover, the situation was followed by the global crisis triggered by subprime lending and the collapse of Lehman Brothers in 2008. Currently, the number of listed companies in the newly-established markets in Japan is approximately 1,000,⁶⁾ while the aggregate market value of listed shares reached its apex during the December 2005-January 2006 period (when livedoor was delisted), it continue to fall since then (Figure 4).

The amount outstanding of loans to and investment in venture capitals in Japan is presumed to be approximately 1 trillion yen at the moment. The amount is extremely small in comparison with the loans outstanding to small and medium enterprises by Japanese financial institutions which stand at approximately 258 trillion yen⁷⁾. Compared with the United States, the amount corresponds only to 1/30 in the market size, suggesting that there is great room for growth although predominantly indirect pattern of funding prevails in Japan. What is indispensable in expanding availability of risk money is invigorated markets, of which Japanese newly-established markets find themselves in predicament as depressed stock price is negatively affecting not only fundraising by venture businesses but recovery of investment as well. Decrease in fundraising in the market prompted an array of enterprises to forgo IPO; this in turn derailed the projected recovery of invested

6) Since the inception of Tokyo Stock Exchange Mothers, the aggregate of JASDAQ, JASDAQ-NEO, Hercules, Ambitious, and Q-board.

7) “Financial and Economic Statistics Monthly,” Bank of Japan

(Figure 4) Changes in aggregate market value in newly-established market.



(Source: Compiled by the author based on the Market data in TSE and OSE Stock Exchanges)

money by venture capitals as investors, which resulted in slowing down of new fund establishment, that is to say, supply of new risk money. In addition, there is also “the 2007 problem” which means the simultaneous arrival of maturity in 2007 or thereabout of those funds that had been created one after another in about 2000. It is indeed difficult to close a fund in a depressed market. Since 2006, both the number of new fund launching and the total amount of new investment fell drastically. After the collapse of Lehman Brothers, it became extremely difficult to start a new fund.

Currently, the problems that beleaguer newly-established markets can be summarized as the following:

- Fund supply problems related to venture financing for enterprises.
- Re-development of markets that can smoothly realize IPO and reflect corporate value appropriately.
- Observance of compliance by enterprises and establishment of adequate systems for its accomplishment.

These problems involve complicated factors and the solution cannot be expected any time soon. Improvement of conditions surrounding newly-established markets are steadily making significant progress with the opening of Tokyo AIM, a market for professionals, in addition to measures for strengthen internal control and compliance

by companies as noticed in the enforcement of the Financial Instruments and Exchange Act (Japanese version of US Sarbanes-Oxley Act). Thus there has been a great stride forward toward better investor protection and information disclosure. Such measures, however, have become causes of cost increase and, together with economic depression, are making it more difficult to achieve listing in the market. It may be said that newly-established markets in Japan find themselves at the cross road to simultaneously maintain both dynamism and order of the markets.

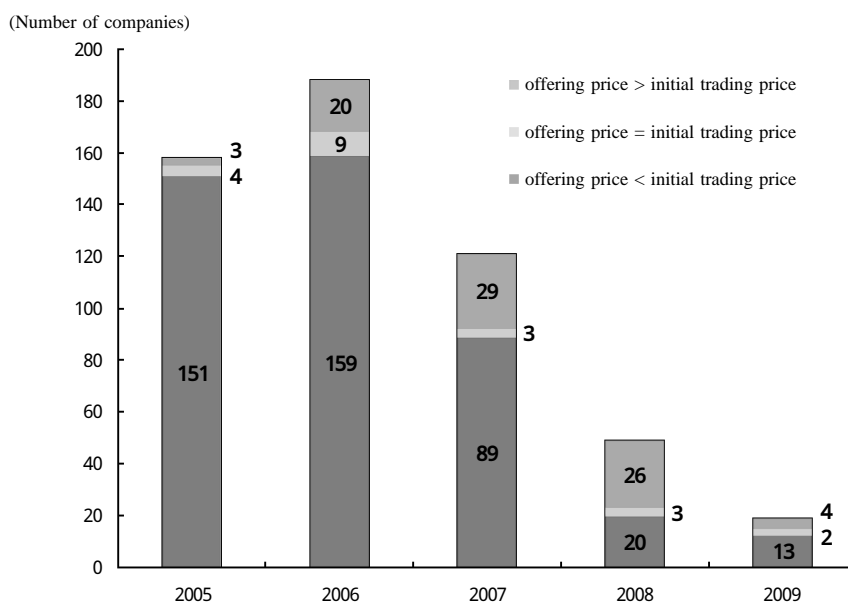
3. Effects of Venture Finance

–Summarized from the recent IPO case of SMRJ

(1) Current condition of IPO in Japan

As described in the preceding chapter, it is quite difficult for small and medium enterprises to raise fund from the markets at the moment. Particularly, IPO in the stock markets by those companies that venture funds targeted, drastically decreased in number to the level below the level of 100 cases for two consecutive years from

(Figure 5) Number of IPO cases in Japan and difference between offered price and initial trading price.



(Source: Compiled by the author based on the Market data in TSE and OSE Stock Exchanges)

2008. In 2009 there took place only 19 cases of IPO (**Figure 5**). Furthermore, of those firms that completed IPO, more than half experienced the initial trading price in the market that went below the offered price. There are cases where enterprises decided to forgo listing seeing no advantage in listing as the pricing go far below the planned target in spite of going through strict and severe reviewing to meet the criteria for listing. As the stock price tends to remain stagnant even after the completion of listing, it has ceased to be a successful goal not only for venture capitals but for enterprises as well.

(2) Recent IPO cases by SMRJ

How much investment for venture finance was made by SMRJ in such an environment? The market situation is as unfavorable to the funds of SMRJ as any other funds. In terms of listing in the stock markets (IPO), 96 companies achieved listing with investment from the funds in which SMRJ invested. Of them, 10 firms (among 68 in all the markets) succeeded in listing since IPO activities stalled in 2008. Hence, the share of enterprises assisted by SMRJ should be regarded extremely high.

Why the venture funds of SMRJ have been able to generate such a large number of IPO-successful companies in lackluster markets? First, your attention is called to the types of businesses to be listed. Figure 6 shows the IPO companies with investment from the funds of SMRJ since 2008. Of the 10 companies, 8 are pharmaceutical and bio ventures while each of the remaining represents semi-conductor or IT related business. While depressed economy imposes stricter investment selection, bio and semi-conductor businesses present more easily understandable business models as results of research can be visibly commercialized as new drugs or products. Moreover, the product target will not be limited to the domestic market but can include global customers, hence they are judged more favorably by investors⁸⁾.

Secondly, in terms of location of the IPO companies, there are those in regional areas such as Chiba, Hiroshima, and Shizuoka, not limited to big metropolises like

8) For basic concept of business models for bio-ventures see “Changing Bio-portfolio (4) Three Business Models (lessons given by professionals to make scales fall from your eyes’

Tokyo and Osaka. As shown in **Figure 3**, the funds of SMRJ offered, through direct investment, a new way of fundraising to enterprises that require huge amount of capital resources such as bio and semiconductor sectors with risks exceeding what private investor could bear, or seeds business like ventures from academic laboratories, or businesses located in regional areas. While many venture capital companies recently shifted their investment targets toward those in venture businesses near IPO, namely so-called later stage investment, or toward merger & acquisition projects,⁹⁾ the degree of success in IPO achieved by SMRJ proves to be the result of continued investment in research-based seeds ventures in local regions¹⁰⁾.

Lastly, though the effects are not limited to the companies with investment by SMRJ, it was decided for the purpose of strengthening internal corporate control that the Financial Instruments and Exchange Act (Japanese version of US Sarbanes-Oxley Act) is applied to all the companies listed in the stock exchanges effective April 1, 2008. This makes cost of listing more expensive, including statutory auditing and makes listing more difficult, but it will drastically strengthen investors' confidence. As a consequence, evaluation of listed companies will become clearer and long-term effects on stock price and fundraising will turn out to be favorable in the long run¹¹⁾.

4. Conclusion

So far, I have discussed on direct investment in small and medium enterprises in Japan focusing on venture fund activities of SMRJ. Despite the fact that for small and medium enterprises fundraising through direct investment is still limited in amount, the markets as a whole have institutionally become one of the most

9) Fiscal Year 2005 "Nikkei Venture Capital Research" (2005)

10) For the records of investment in regional areas by Small and Medium Enterprise Organization, see "Fiscal Year 2008, Venture Related Collection of Information, Presentation and Research Project 'Follow-up Research on Investment to Promote New Business Development'" pp. 27-28.

11) For Financial Instrument and Exchange Law, please refer to "Research and Study on Venture Finance" by Management Support Information Center of the Organization for Small & Medium Enterprises and Regional Innovation, JAPAN (2008).

important ones as a number of new stock markets have been established and legislative frameworks for investor protection and internal corporate control such as the Financial Instruments and Exchange Act (Japanese version of US Sarbanes-Oxley Act) has been developed. While the challenge from now on will be how to invite and nurture promising businesses but before that, launching of new funds is first expected to invest in new ventures. The prevailing conditions remain unfavorable for creation of new venture funds. It is considered, however, that as stated in the preceding chapter, corporate value will be correctly assessed and reflected in stock price for strictly selected companies that achieved listing with clear business models even in the period of economic recession. I expect that new venture funds that will be launched in coming months will build up investment vision in full consideration of the above institutional environment to become promoting force for the birth of new industries.

(Figure 6) IPO Companies with Investment from the Funds of SMRJ

Company name	Scopes of Business	Head office	IPO Date	IPO Market
NanaCarrier Co.,Ltd.	R&D and production of Pharmaceuticals	Chiba	Mar-08	Mothers
SMS Co.Ltd.	Recruiting and media businesses in nursing care, healthcare and active senior fields.	Tokyo	Mar-08	Mothers
Billing System Corporation	Provision of an internet-based account settlement service	Tokyo	Mar-08	Mothers
Carna Biosciences, Inc.	Development of drugs and also offers drug discovery supporting products and services	Hvogo	Mar-08	JASDAQ Neo
DATA HORIZON CO., LTD.	Receipt computing service for cost cutting and health promotion purposes	Hiroshima	Sep-08	Mothers
Linical Co., Ltd.	Contract research organization (CRO) business for pharmaceutical companies.	Osaka	Oct-08	Mothers
tella, Inc.	Medical support business	Tokyo	Mar-09	JASDAQ Neo
CanBas Co., Ltd.	Research and development of anticancer drug having fewer impact on normal cells	Shizuoka	Sep-09	Mothers
D. Western Therapeutics Institute, Inc.	Pharmaceutical R&D	Aichi	Oct-09	JASDAQ Neo
FOI Corporation	Manufacture of semiconductor fabrication equipment	Kanagawa	Nqv-09	Mothers

(Source: Website of SMRJ, <http://www.smrj.go.jp/>)

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