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Startup Investments in Japan

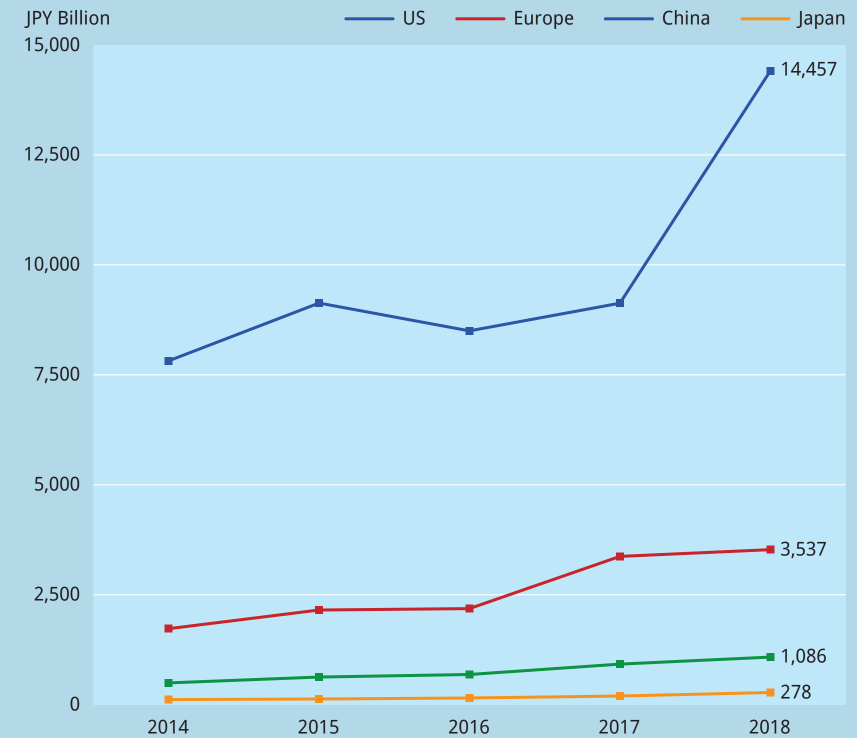
Japan's Startup Investment Small Relative to Economy's Scale

The Japanese government's Growth Strategy 2018, announced in June 2018, established a number of key performance indicators (KPIs), one of which is to create 20 unlisted (unicorn) or listed venture companies with an enterprise value or market capitalization of USD 1 billion or more by 2023. According to CB Insights, a US research enterprise, as of end-April 2020 the United States had 223 unicorns (unlisted ventures with an estimated value of USD 1 billion or more) and China had 119. Japan, however, had only three, an extremely small number relative to the scale of the country's economy based on GDP and other indicators.

One reason for the small number of unicorns in Japan is the level of investment in startups in Japan. In Japan, total investment in startups is only about one-fiftieth of that in the US and one-tenth that in China (Figure 1). Looking at the total amount of investments in startups relative to a country's GDP, Japan ranks 19th among OECD member countries. Japan's startup investment to GDP ratio is just 0.03%, compared with 0.4% for the US, which tops this ranking.*1

However, investment in startups in Japan has been increasing in recent years, and changes can be seen in Japan's startup ecosystem.

Figure 1: Comparison of Countries' Total Investment in Startups



Notes: (1) Japan figures are on a fiscal year basis, with each year's figure representing the total investment for the 12 months ending on 31 March of the following year.
(2) US data includes investment in venture capital firms by nonfinancial companies.
Source: Venture Enterprise Center's "VEC Yearbook 2019"

Special Characteristics of Startup Investments in Japan

Looking at the trend in startup investments (including corporate acquisitions and investments to make a venture a subsidiary) in Japan since 2010 reveals these investments have been rising sharply since 2014 (Figure 2). Total annual startup investment quadrupled from 2013 to 2018. Generally speaking, this increase was fueled by financial deregulation from 2014 paving the way for large sums of money to be invested in startups and by the Japanese government implementing a series of measures to support startups as part of its Japan Revitalization Strategy.

In 2019, startup investment was led by venture capital firms (VCs), accounting for 46% of the total amount invested, followed by nonfinancial companies, at 30%. Nonfinancial companies' investment in startups in 2018 was more than five times greater than in 2013. Moreover, as will be discussed later, nonfinancial companies make up about one-third of the investors in VCs. Accordingly, large corporations have been driving the growth in startup investment in Japan.

Startup investment by large corporations

Startup investment by nonfinancial companies, especially large corporations, includes investment by the companies themselves as well as investment by corporate venture capital firms (CVCs) set up by these companies. The establishment of these CVCs has increased as nonfinancial companies have expanded their investments in startups. Close to 90 CVCs were established from 2014 to end-2019.*[2]

Asked what the purpose of establishing a CVC firm is, more than 80% of the establishing nonfinancial companies cited "business synergies", with 24% citing "business synergies only", 45% saying "business synergies are the main purpose, but financial returns also are expected", and another 13% saying that "financial returns are the main purpose, but business synergies also are expected". This investment in CVCs seems to indicate that Japanese companies, which to date have accumulated core technologies and other strengths on their own, are beset by a growing sense of crisis that they are unable to keep up with rapidly changing times. A growing awareness that it is difficult to create innovative new businesses under existing corporate organizations and frameworks has led companies to establish CVCs as units that complement R&D organizations in the effort to create new businesses through an open innovation approach.

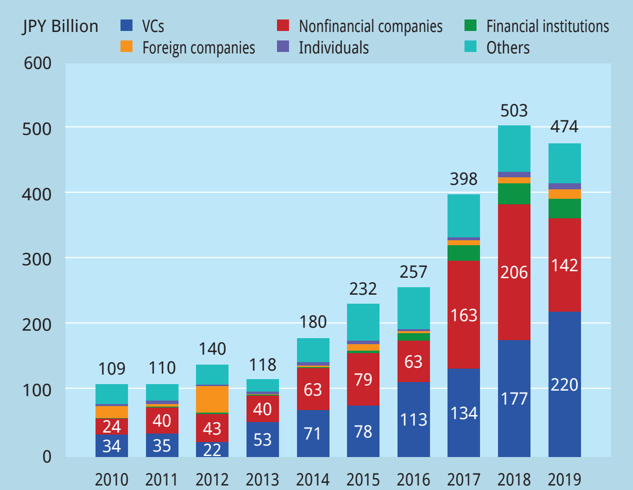
Venture capital firms (VCs)

In all countries, venture capital plays the major role in startup investments. In Japan, the term "venture business" has been used for companies that invest venture capital in startups. Japan's first private-sector VC firm was established in 1972. Since then, the number and size of VCs have both expanded. During fiscal 2018, 51 VCs were established, with a total value of JPY 237.5 billion. As of May 2020, the Japan Venture Capital Association counts more than 100 VCs among its members. A large number of independent VCs is crucial for supporting diversity among startups.

In fiscal 2018, 37% of the investment in VCs was by nonfinancial companies (Figure 3). This is a major feature of venture capital in Japan. If nonfinancial companies' motive for investing in VCs is primarily business synergies rather than financial returns, as is the case with their establishment of CVCs, the nature of VCs' investment could be affected.

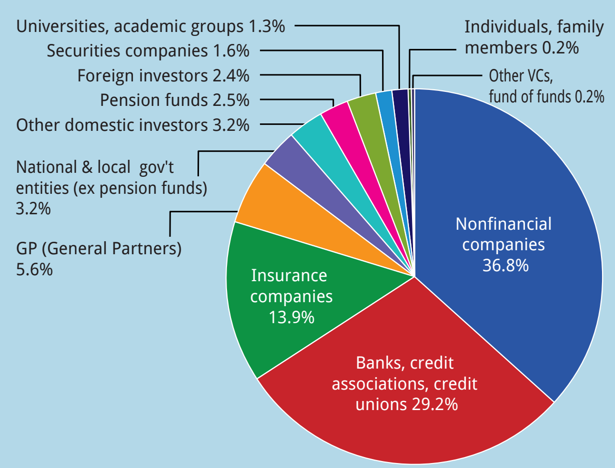
Meanwhile, pension funds accounted for just 2.5% of VCs' funding. In the US, the development and advancement of VCs and startups is considered to have been greatly promoted by the relaxation of the prudent-man rule set forth in ERISA (Employee Retirement Income Security Act of 1974) in 1979, because it led to large inflows of pension and other funds into VCs. Today, pension funds are one of the main investors in VCs in the US. How to attract funds from pension funds and other in-

Figure 2: Startup Investment Trend in Japan (by Investor Type)



Note: "Others" is composed of non-categorized investor types and unknown investors.
Source: "Japan Startup Finance 2019", INITIAL, Inc. (as of March 27, 2020)

Figure 3: Composition of VCs' Funding, by Investor Category



Note: (1) Investment in VC funds newly formed during April 2018–March 2019 by investor category.
(2) VC funds sample number = 22.
Source: Venture Enterprise Center's "VEC Yearbook 2019"

stitutional investors has become a major issue for Japan's venture capital industry.

Public-private fund

Amid the chilly investment environment during the global financial crisis triggered by the collapse of Lehman Brothers in 2008, investment in startups was supported by the establishment of the Innovation Network Corporation of Japan (INCJ). The INCJ was created in 2009 under the Act on Special Measures Concerning Industrial Revitalization and Innovation of Industrial Activities as a temporary 15-year public-private partnership with the government providing 90% of its capital and the remainder coming from 26 private-sector companies, including Toyota Motor Corporation and Hitachi, Ltd. The INCJ invested a total of JPY 270.9 billion in 110 startups from fiscal 2011 to fiscal 2018. During the global financial crisis that occurred after the collapse of Lehman Brothers, INCJ supported Japanese startup investment by providing 25% of the capital invested in new startups in 2009-2013.

Foreign investors

One reason for the small amount of investment from overseas is the relatively small size of startup investments in Japan.

In recent years, US mutual funds have included unlisted Japanese companies among the targets for their investments in startups. For example, in August 2018, Fidelity Investments (Japan) Limited invested in Raksul Inc., a startup company that provides printing and offline advertising services via the internet and was subsequently listed on the Tokyo Stock Exchange's Mothers market in May 2018. Another example is the T. Rowe Price Japan Fund's December 2018 investment in Sansan, Inc., a provider of cloud-based business card management services that listed on the TSE Mothers market in June 2019.

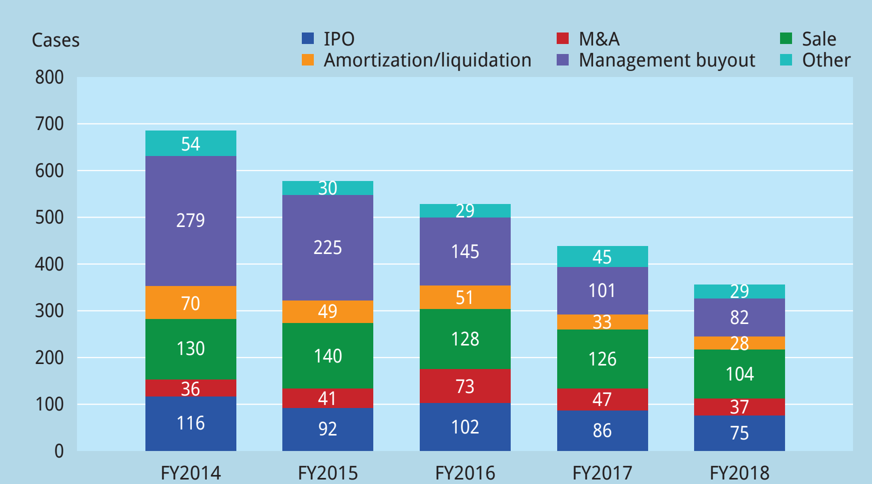
In the Startup Ecosystem Rankings that rank the world's cities based on their startup ecosystem activity level, Tokyo was ranked 14th in 2019, up 15 places from the previous year's rankings.*3 However, the report noted that "Japan will probably not be able to climb the ranks much further without a noticeable increase in English proficiency among local entrepreneurs." Japanese startups therefore need to better communicate their message to investors around the world.

Startup exits

In the US, M&As are overwhelmingly the most commonly used exit route from startup investments. In 2018, there were 779 M&As involving startup ventures compared to just 85 IPOs. In Japan, however, IPOs are more popular than M&As. In 2018, IPOs accounted for 21% of all VC exits from startup investments, as opposed to just 10% for M&As (Figure 4).

Exits from startup investments in Japan have declined each year since 2014 for three main reasons. (1) Strategic investments, especially by CVCs, have increased, resulting in more cases where the investor continues to hold its equity stake in the startup rather than exiting. (2) An expansion in investment targets has increased the number of startups requiring larger amounts of capital and time to build their businesses. (3) Startups seeking to be unicorns are not in a hurry to get to the exit stage.

Figure 4: Trend in Startup Exits in Japan



Source: Venture Enterprise Center's "VEC Yearbook 2019"

US Crossover Investments

Investments in unlisted companies by mutual funds and hedge funds, which mainly invest in listed companies, are called "crossover investments" in the sense that they cross the boundary between investing in listed and unlisted companies. An overview of US crossover investments may provide some insights into the future for startup investments in Japan.

In recent years, mutual funds and hedge funds have joined VCs as major investors in unlisted companies in the United States. For example, 55 mutual funds invested in Uber Technologies Inc. before its IPO.

Mutual funds recent aggressive stance on investing in startups is generally thought to be motivated by two major reasons. The first is that investors who wait for an IPO may miss out on an important stage in a company's growth cycle. The second is that, because startups often bring about innovation and creative destruction, an accurate understanding of a company's competitive position requires the investor to look at all players in that company's field, including listed companies and startups.

However, because unlisted companies' stocks are not priced on a stock exchange, one must evaluate the prices assigned to investment targets by each investment company. Startups (unlisted companies) are not subjected to the same information disclosure requirements that apply to listed companies. Interested mutual fund management companies must therefore independently collect information about startup investment candidates. As a result, they generally need more time to monitor a startup's business conditions and determine a valuation for the company's equity than is needed for listed companies. Crossover investments therefore are generally better suited for large funds that have an abundance of analytical resources.

The merits of crossover investments for startups

Having a major mutual fund listed as a shareholder before its IPO enables a startup to appeal to the broader equity market that its company management and information disclosures have reached a certain level.

Being able to remain an unlisted company for a long period of time after securing necessary funding is a huge advantage for a startup's management team. The flip side of this coin, however, is that VCs that invested in the startup in its early stages must wait longer for an exit, while the company's employee shareholders also must wait longer for an opportunity to sell their shares on the open market. To secure and keep talented staff while also reducing pressure from employees for an IPO, some startups allow employees to sell their shares under certain conditions. On the other hand, institutional investors are keen to invest in the equity of startups, and especially in unicorns, that are expected to achieve strong growth.

The sale of holdings by existing shareholders (including company directors, employees, VCs, and others) before an IPO is called a "secondary sale". The scale of such transactions is expanding as the assumed market capitalization of unicorn companies increases. This is leading some major investors to form consortiums that make tender offers to acquire large numbers of shares held by existing shareholders.

The roles played by mutual funds' investments in unlisted companies

Mutual funds that have become crossover investors have become major players in the startup ecosystem. These mutual funds have become a major source of large financings conducted in a startup's ultra-late stage before an IPO. They also provide liquidity to a startup's initial investors, including its employees. Mutual funds will, in some cases, act as lead investors for a startup's financing, but unlike hedge funds, the other type of crossover investor, they do not get directly involved in the management of the unlisted companies by dispatching directors to the company. Nonetheless, by providing the equity capital that startups need to grow, they can promote the pre-IPO growth of unlisted companies and enhance their own funds' return. In addition, they are providing individual investors invested in mutual funds with an indirect opportunity to invest in unlisted companies.

As noted earlier, US mutual funds are already investing in unlisted companies in Japan. Going forward, the promotion of crossover investment will probably be important for promoting innovation and enhancing support for venture firms in Japan.

The Road Ahead

Going forward, the following two factors are expected to support the expansion of startup investments in Japan.

Initiatives to realize crossover investments

Investors in Japan are beginning to see the need for greater crossover investment. The "Ito Review 2.0 – Biomedical Edition" published by the Ministry of Economy, Trade and Industry (METI) in April 2018 emphasized that one of the challenges faced by Japanese drug discovery ventures seeking finance is the lack of crossover investors in Japan and the lack of VCs' support for IPOs. In addition, METI's Study Group for Risk Capital Supply for the Fourth Industrial Revolution pointed out that classification of companies as listed or unlisted has resulted in a very small group of providers of risk capital money and business knowledge to companies in the narrow space made up of companies that have just listed their shares on a stock exchange. The study group concludes that the lack of professional investors active in this zone may be a bottleneck for creating new industries.

Pension funds can play an important investment role as crossover investors who invest before an IPO and continue to hold the company's shares after the IPO. In the United States, pension funds have been a key provider of venture capital through their investment in VCs, but in recent years the pension funds have been shifting to in-house investment to improve their investment performance.

Japan too should consider initiatives to support more proactive crossover investment by institutional investors and especially pension funds. If institutional funds such as pension funds, which make long-term investments not bound by the typical investment fund's fixed period, become more active in venture investment, the pool of risk capital available to startup companies will become much deeper.

Platform for pre-IPO equity sales

In Japan, startups have been buying back stock allocated to their employees in preparation for an IPO. Some startups think they need to move quickly to the IPO stage in order to prevent an exodus of talented staff. It therefore is necessary to consider creating opportunities for a startup's original shareholders, such as employees and VCs, to cash in their shares.

For that purpose, Japan needs to follow the US example and create a platform for mediating sales of unlisted stock. However, rather than broadly targeting individual investors, this platform should seek to accelerate the process by limiting investment to pension funds and other institutional investors that can be expected to be hold shares for a long period of time and relaxing the information disclosure and other regulations usually required for public stock sales.

To increase the size of startups in Japan, an environment that enables startups to procure necessary funding must be established. In other words, investors willing and able to provide the necessary funding are needed. Funding provided by investments from domestic VCs is insufficient. Japan's startup ecosystem needs to be enhanced by measures that will encourage crossover investment from suppliers of risk capital and increase the liquidity of unlisted stocks.

Notes

*1 OECD, "Entrepreneurship at a Glance 2018 Highlights."

*2 INITIAL, "Japan Startup Finance 2019."

*3 Startup Blink, "Startup Ecosystem Rankings 2019."

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Satoshi Takeshita has been a Senior Analyst at Nomura Institute of Capital Markets Research (NICMR) since 2017. His main research coverage includes corporate finance and alternative Investments.

Prior to his current role, he has held positions as a researcher at Nomura Securities Financial Research Center, Nomura Research Institute and the Institute of Fiscal and Monetary Policy (currently Policy Research Institute) Ministry of Finance Japan. He earned his BA degree from Keio University.