

JAPAN

SEEKING 'QUALITY CAPITALISTS'

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INTRODUCTION

The supply of risk money in Japan remains relatively limited compared with economies of a similar size, such as the USA or China, but the total amount invested per year is growing significantly. There has been a sharp increase, over the past decade, in funds raised by start-ups. Mid-to-large corporations are also increasingly using fund functions for restructuring or business succession. And there is a trend of strategic equity investments for mid- to-long- term by Japanese corporates.

This Qodeo report brings unique insights into the background and activities of venture capital and private equity firms in Japan. It also provides some general commentary on the investment and entrepreneurial VC & PE community in the country. It was compiled before the global coronavirus pandemic so although it can offer no insight into the impact of that on business, it does offer a comprehensive overview of the state of the market and an insight into new and emerging trends.

As part of a research project for Qodeo during her MBA at Cambridge Judge Business School, Keiko spoke with around 30 firms across Japan, to identify key trends in the industry and views of and trends identified by its stakeholders. Interviews took place in August - September 2019.

Here we share their unique insight into industry trends and their medium-and long-term outlook.

VC MARKET OVERVIEW

Since the 2012 general election, Japan's prime minister Shinzo Abe has pursued an economic growth strategy divided into three sections, or "arrows". Boosting venture capital investment is a key component of the "third arrow" of what has come to be known as Abenomics. The supply of funds from VC is still relatively small, when compared with China or the US - but there has been a sharp increase in investment in start-ups in the past decade. Funds managed by the firms interviewed have also steadily increased in size.

VC investment in Artificial Intelligence (AI) and the Internet of Things (IoT) - and other areas linked to the "fourth industrial revolution" - are increasing. Many of the companies interviewed for this project had investments in AI and IoT, in addition to other industrial sectors.

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Entrepreneurs are not simply seeking money as a resource, but rather demanding added value that VCs can provide.

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Start-ups are looking for 'smartmoney'

The diversity of VCs in Japan is rapidly increasing, aided by the structural reform of industry and Prime Minister Abe's "Japan Revitalization Strategy".

Portfolio investments, funding a wide range of industries, have traditionally been the most common vehicles available to investors. These originated from financial institutions, with minority participation from VCs.

However, over the past five to 10 years, Japanese VCs have become more diverse, with different kinds of investment vehicle, including funds targeted at specific industries - and foreign VCs have become increasingly active in the market.

One CEO of VC firm told us: "Recently, VCs have been exposed to global and more severe competition. In order not to miss invaluable investment opportunities, we need to differentiate and possess competitive value proposition."

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“Recently, VCs have been exposed to global and more severe competition,”

CEO OF VC COMPANY

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70% of firms interviewed assist with business development



VC Hot Sectors

- Technology
- Manufacturing / Construction
- Healthcare / Lifescience
- AI
- Saas
- Value chain
- IoT
- Robotics
- Fintech / Insuretech
- Legal tech
- biotech
- Foodtech
- Mobility
- e-commerce
- Communication
- Relaxation

GROWING TREND IN VALUE-UP AND HANDS-ON FUNDS

The increase in value-up and hands-on funds could potentially overcome the limitations of the traditional general funds. For example, financial institutions' funds used to have the role of sourcing future borrowers for the banks and they did not necessarily put proactive efforts to lead speedy commercialization and growth.

In recent years, the idea that it is important for VCs to deepen their direct involvement with investees in order to improve corporate value has spread. Mechanisms for increasing value such as enterprise value

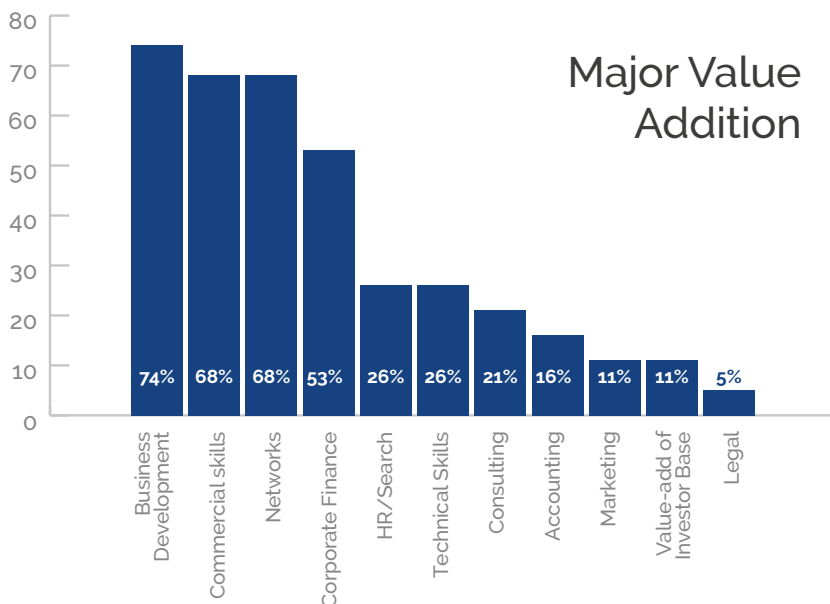
promotion based on business plans and appointing board members, such as CFOs or COOs, are gaining prominence in the industry.

Many firms mentioned that the process of selecting an investment is a two-way process, with the investors being questioned by the entrepreneurs about what additional value they can provide.

Around 70% of firms interviewed assist with business development, commercial skill improvement and networking to expand their portfolio company's base of customers.

Almost as many of the firms said they provided advice on the strategic direction of companies and helped to drive strategy and operations.

Other areas that a large number of firms assisted with included finance (e.g., corporate finance, fund raising) and HR / search (e.g. recruiting, employee management).



INCREASE IN SPECIALIZED FUNDS

Japan has an increasing number of specialized funds, focusing on areas such as manufacturing (a traditional strength of the Japanese economy), logistics and B2B technology. These tend to be smaller in scale than general VCs and are managed by people with specialist knowledge and insights. When financial professionals and technical/industry professionals are combined well, they can produce greater value and contribute efficiently to the growth of venture companies.

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“People outside Tokyo go to Tokyo to establish their business because there is more risk money over there.”

REGIONAL VC PARTNER

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“The entrepreneurial cultural base needs to be expanded across Japan,”

FOUNDER AND CEO OF VC FIRM

CONCENTRATION IN TOKYO AND LOCAL INITIATIVES

There are few firms that have offices outside the Tokyo metropolitan area. Many of the firms we interviewed in Tokyo told us that there are few start-ups outside Tokyo and that is why they do not have permanent offices there.

Among the VCs outside Tokyo that participated in the interviews, some limited their investment decisions to local start-ups, while others said they ended up having more investees in Tokyo than in their own local area.

One local VC partner said: "People say there are only a few VCs outside Tokyo because of the number of start-ups existing out there. However, it is also the situation that people outside Tokyo go to Tokyo to establish their business because there is more risk money over there. It is a chicken-and-egg problem."

Many firms in regional cities have a mission to promote growth and create industries in their region. On the other hand, there are many that are purely targeting "potential" ventures, regardless of their location.

But one thing they all have in common is a desire to improve the venture ecosystem in their areas. In addition to investing or supporting the value-up of companies, the firms we interviewed are increasing their efforts to create a more fertile environment for entrepreneurs, with the aim of expanding the limited supply of start-ups. Some municipal governments, such as Fukuoka or Kyoto city, are trying to back these efforts up.

The founder and CEO of one firm said: "For instance, Silicon Valley has created a lot of unicorn companies. But not all companies started in Silicon Valley are doing well. Because they have a wider base of start-ups, competitions are created, and growth becomes dramatic. Therefore, the entrepreneurial cultural base needs to be expanded in Japan as well. To that end, it is necessary to support not only the ventures that are already running, but also to support the environment creation that produces entrepreneurs."

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“CVCs (Corporate Venturers) can be an additional funding source for start-ups in an industry, but they may also disrupt the industry’s capital environment,”

**PRINCIPAL, LARGE
TOKYO-BASED VC**

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“Some CVC professionals have limited work experience,”

**INVESTMENT
MANAGER,
TOKYO-BASED VC**

INDUSTRY- GOVERNMENT- ACADEMIA COLLABORATION

University-oriented funds, based around collaboration between industry, government and academia, have developed rapidly over the past five years. The University of Tokyo Edge Capital, founded in 2004, pioneered this approach, by investing in technology created by universities and research institutes from start-up or seed stage, and by actively taking a value-up approach as a lead investor.

But, generally speaking, Japanese industry-government-academia collaboration has lagged behind the US and Europe. Intellectual properties and technologies originating from Japanese universities have not been fully materialized for economic and social return. In an attempt to address this, the government has allocated funding and encouraged universities to support R&D-type venture development. Some venture capitalists said that supporting R&D-type ventures have special difficulties as some researchers are not interested in commercialization or do not want to give up their technologies. Even so, business utilization of cutting-edge

technologies is one of the key areas for the future development of the industry. These funds do not necessarily have to pursue the same level of return as other firms because of government subsidies. Sustainability without public subsidies is important for these initiatives.

CVCS FLOODING INTO THE RACE

There has been a rapid increase in Corporate Venture Capital (CVC) in Japan, as large companies steer away from their own Research and Development to open innovation. For major companies, CVC investments can provide synergies with their own R&D operations and technologies, as well as providing opportunities for cross-business innovation.

On the other hand, CVC may be considered as just one of the investment options for dormant funds within large companies.

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“Entrepreneurs are not simply seeking money, but rather demanding added value that VCs can provide,”

**PARTNER OF
SEVERAL VC FUNDS**

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Most VCs interviewed had a background in PR and marketing, finance or tech/science

The danger here is that there may be no clear philosophy for the investment. If there is also weak pressure from the Limited Partners, these CVCs may not have strong commitment to grow the ventures they invested in. CVC investments are dependent on the management situation of the parent company. So it is no surprise that there were mixed opinions on them from our interviewees.

One investment manager at a Tokyo-based VC told us: "A large proportion of CVCs' professionals are temporarily transferred from their parent company, so some CVC's capitalists have limited work experience and it is also plausible that the commitment to the investees become lower."

The rapid rise of CVC in the Japanese VC industry has a lot of potential but the impact on the market has yet to be fully evaluated.

A principal of larger Tokyo-based VC told us: "CVCs can be an additional funding source for start-ups in an industry, but they may also disrupt the industry's capital environment."

THE MARKET IS SEEKING 'QUALITY CAPITALISTS'

There are new movements emerging in the Japanese VC industry. However, professionals in the industry still see potential barriers to market growth, both from a quality and quantity perspective.

Traditionally, the small number of start-ups in Japan has been an issue. The rate of entrepreneurship remains among the lowest in the developed world, but things are changing. There has been a growth in the number of start-ups in recent years - and the venture capitalists we spoke to who had developed their career outside Japan spoke about the growing number of talented entrepreneurs in the country.

On the other hand, several of our interviewees saw room for improvement when it comes to supporting entrepreneurs. Industry professionals know a venture capitalist is required not only to invest, but also to be a partner who grows the company together by providing management guidance to the entrepreneurs. They say what the industry requires urgently is an increase in the number of those "capable capitalists". It seems that VCs in Japan have diverse teams, with professionals drawing expertise from a variety of different backgrounds.

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What the industry requires urgently is an increase in the number of "capable capitalists"

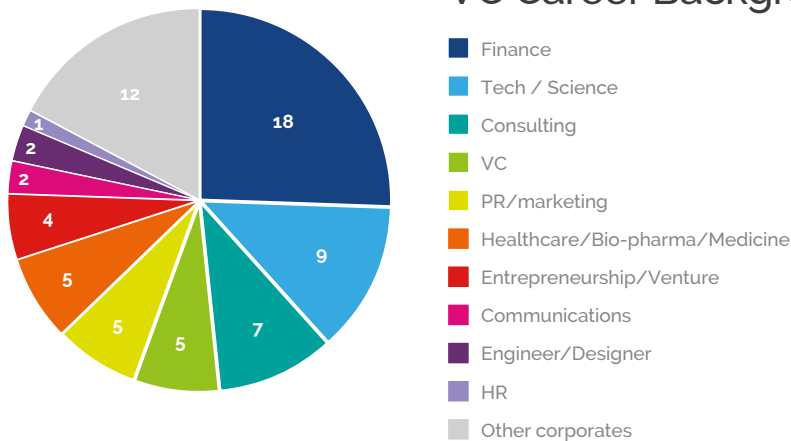
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Most VCs interviewed had a background in PR and marketing, finance or tech/science

However, there are not many with entrepreneurial experience, or a background in tech, science or engineering, compared with the US.

Venture capitalism has only just started to become an attractive career option in Japan. As the market grows, so will the demand for higher quality capitalists.

VC Career Background



PRIVATE EQUITY AND LATER STAGE SCENE

Private Equity (later stage) activity has grown steadily in Japan since the first buyout fund was established in the late 1990s. The market shrank after the 2008 Lehman crisis, but the total number of funds in Japan has now recovered. The firms interviewed for this project said there was a sense that the concept of buyout funds had now penetrated into the wider Japanese business culture, although some smaller, local companies still clung on to the image of "vulture funds", particularly if the fund was based abroad.

For large corporations, buyout funds have become an indispensable tool for restructuring businesses, such as non-core, carve-out projects.

Furthermore, the need to plan for succession is increasing rapidly, with the aging of small and medium-sized business owners in Japan. Many firms indicated in their interviews that the number of carve-out and business succession projects has been increasing.

Unlike the venture capitalists we surveyed, there was no firm specializing in specific sectors.

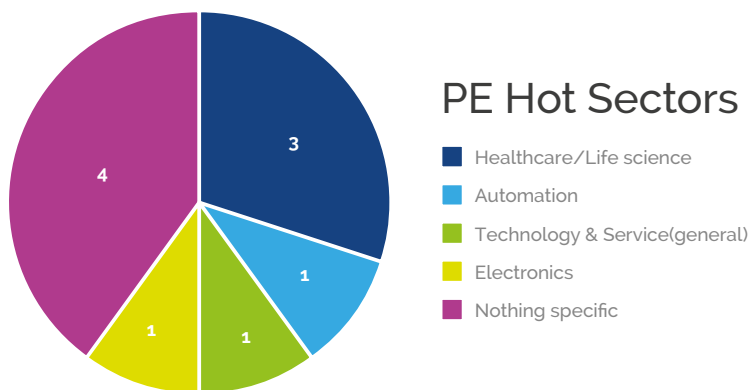
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The number of carve-out and business succession projects has been increasing

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Return performances of Japanese transactions have been high in recent years

A VP of a firm noted that M&A market in Japan is still relatively small and there are not many deals. That means Private Equity cannot be sector-specific. As a result, many firms told us there was no specific hot sector for them. What some firms said instead was that there are still many carve-out opportunities from conglomerates. Given the nature of Japanese conglomerates, these tended to be in the electronics or pharmaceutical sectors.



As for the VC segment, several firms noted volume and quality issues in buyout investment. In terms of volume, foreign funds cover the majority of large projects, while Japanese funds cover the area below the mid cap. A healthy competitive relationship between domestic and foreign companies is indispensable.

The number of large-scale projects is small compared to the amount of funds. But although there are fewer deals compared to the United States and some European countries, return performances of Japanese deals have been high in recent years, which has generated much attention from foreign investors. It has also meant the fund sizes of each firm are getting larger. However, because the overall number of deals is relatively small, some large caps have difficulties concluding deals for several years. Some noted that several firms end up participating in only bid-sourced projects because they cannot source deals independently.

One firm was concerned about the recent high stock prices in Japan. If stocks remain high, it becomes harder for buyout funds to purchase with an appropriate valuation, which makes it more difficult for them to make an investment decision.

In terms of quality, it is important for strategic exits to be the main exit scenario. However, there are still a large number of inter-fund transactions. Japanese operating companies' sense of synergistic strategy could be developed further.

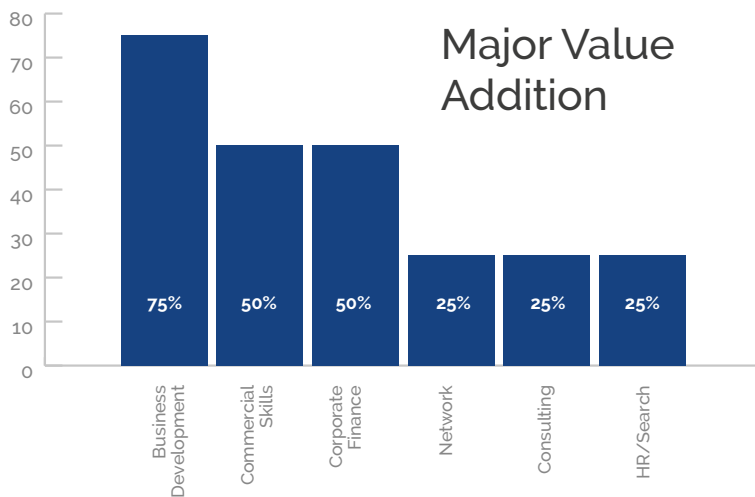
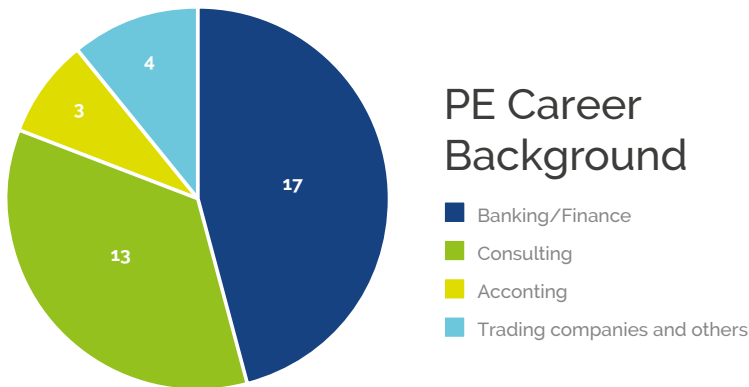
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The total number of deals is relatively small

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PE investment professionals in Japan have less diverse backgrounds than their VC counterparts

With regard to human resources, some say there is a lack of expertise. PE investment professionals in Japan have less diverse backgrounds than their VC counterparts. Most come from investment banking or management consulting. A few firms support their investee companies by dispatching their inhouse professionals on a full-time basis for several years - but most keep their support at an upstream level. Many firms draw up strategies - such as for recruitment or a 100-days plan - but outsource the actual execution to talented CxOs hired from their own network or by partnering with HR agencies.



VC INVESTMENT STRATEGIES

VC firms in Japan are more focused on early stage investment and there are only a few firms looking to expand to markets outside Japan by co-investing with local investors in other markets. Many firms consider VC work a highly-localized business.

The majority of VCs currently source their deal flow through their trusted networks, mainly through primary networks of venture capitalists. Therefore, it becomes an important asset for the firm

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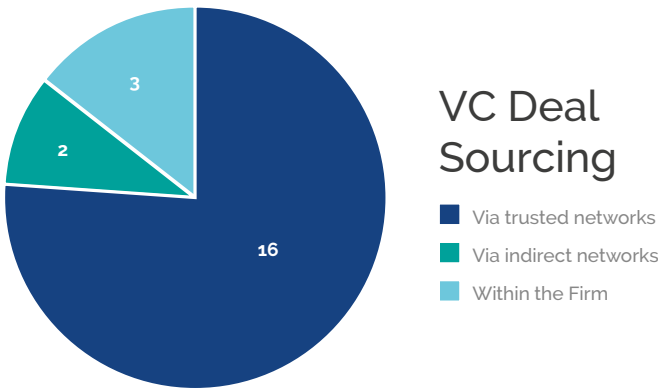
“VC is a localized business. We usually invest to ventures that locate in the area within a 30 minute drive.”

DIRECTOR AND PARTNER, VC OUTSIDE TOKYO

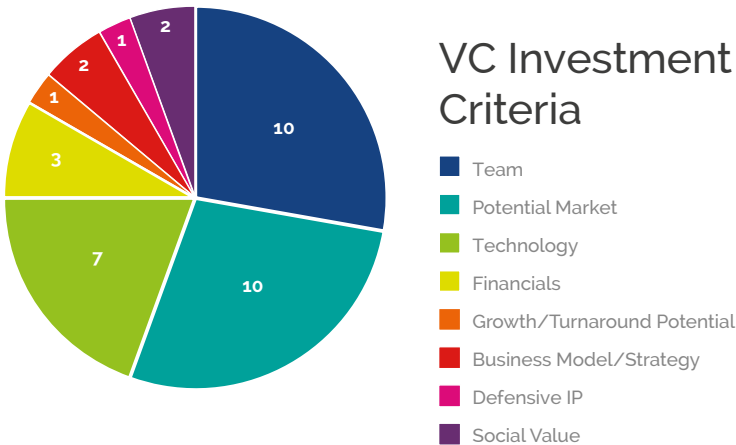
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The majority of VCs source deals through their trusted networks

how its capitalists have developed their networks in the market. Venture capitalists get exposed to potential deals at start-up events and through social networking, or word-of-mouth from their fellow investors and current investees. Many of those working for prominent firms told us that reputation and trust from other investors is very important. They added that it is often the case that co-investments happen based on their trusted networks.



VC firms place more emphasis on team composition than PE firms, probably mainly due to investments being early stage. Few VCs are open to providing patient capital (more than 10 years to exit), based on their company's mission such as regional promotion. Others target the market standard for exit timing, for accountability to their LPs, and manage their portfolios by diversifying investment decisions.



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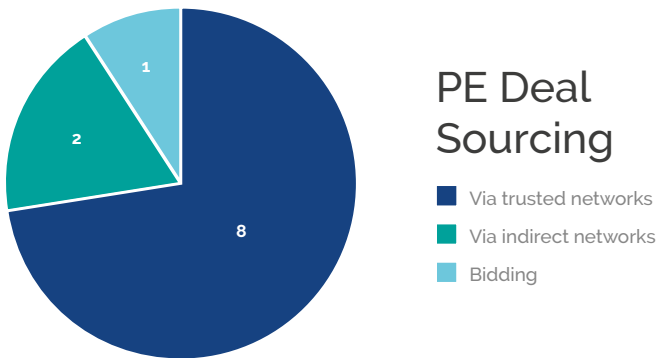
VCs place more emphasis on team composition than PE firms

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Few VCs are open to providing patient capital

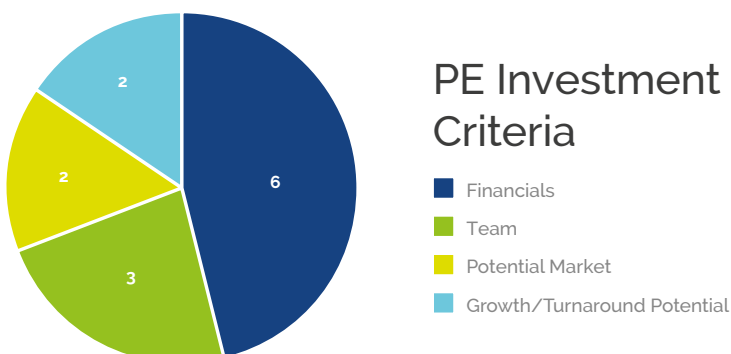
PE INVESTMENT STRATEGIES

PE firms in Japan focus on growth or expansion stage investment, and invest only in revenue-generating companies, similar to other markets globally. Buyout funds also source deals from investment professionals' networks, as VC firms do. However, they have more structured networks, with investment banks to screen and to target potential deals. Many firms participate in bidding, although it does not make up the majority of their deal sourcing.



In terms of location, PE firms in Japan focus on deals inside Japan, while their fund sources are becoming more and more global. Some foreign firms are managing funds regionally, together with investments in other countries, but the Tokyo office does deal sourcing inside Japan. Moreover, there are very few offices outside Tokyo. Firms explained that it is not resource-efficient to maintain offices outside the capital city, given then number of deals that happen there.

On the other hand, PE firms in Japan do not limit their investment to specific sectors, but try to diversify to reduce risk. Compared to early stage VC firms, buyout fund investment requires less technical knowledge. Instead, the focus is on financial skills that are relevant across different sectors. The PE firms interviewed placed a much bigger emphasis on financials in their investment criteria than the VCs we spoke to, and less of an emphasis on teams.



Japanese PE firms focus on deals inside Japan



Fund sources are becoming increasingly global

VC MARKET OUTLOOK

The Japanese VC market is still considerably smaller in scale than the US market. Even so, the number of start-ups in the Internet of Things (IoT), Artificial Intelligence (AI), and Software as a Service (SaaS) sectors has increased. This has accelerated societal change and entrepreneurship. In such circumstances, the role of VCs, in supplying risk money to start-ups, is critical.

The Japanese venture community has entered its next stage by overcoming the quantity challenge of money and start-ups. What emerged most from our interviews was the need for well-rounded, thoughtful investment and appropriate placement of funds. Without properly thought-through allocation of funds, temporary VC heat will spoil promising entrepreneurs and hinder their growth, rather than develop the industry as a whole. But with a growing number of top-notch professionals, the Japanese venture ecosystem is expected to grow even further.

PE MARKET OUTLOOK

In the past decade, the utilization of buyout funds has gathered momentum in Japan. After recovering from the Lehman shock, the supply of money has been expanded and indigenous Japanese funds have increased in size. The inflow of foreign funds is also increasing, despite high stock prices and higher valuations. This is because of the size of the economy, low interest rates for leveraging, and the relatively strong performance of recent Japanese projects. Overall, the Japanese market is currently attracting attention in the PE industry, which may continue for some time.

However, there were many voices suggesting that the supply of funds exceeds that of demand in the PE market. If the surplus continues to grow, some firms with money, but lacking in quality, are likely to struggle.

When the down cycle of the economy comes in the future, the buyout market may become polarized and lower quality funds, or those with low market penetration, will be ejected from the Japanese market.

ORGANISATIONS INTERVIEWED

Fukuoka

- Dogan Beta Inc.
- FFG Venture Business Partners Co., Ltd.

Kyoto

- Darma Tech Labs Inc.
- Future Venture Capital Co., Ltd.
- Kyoto University Innovation Capital Co., Ltd.

Osaka

- OSAKA University Venture Capital Co., Ltd.

Tokyo

- IDATEN Ventures LLC.
- The Longreach Group Ltd.
- Archetype Ventures
- DCM Ventures
- DNX Ventures
- Integral Corporation
- Global Brain Co., Ltd.
- Plug and Play Japan Polaris Capital Group Co., Ltd.
- Creation of Entre Capital Co.,Ltd.
- Unison Capital, Inc
- JAFCO Co., Ltd.
- STRIVE (STRIVE III Limited Liability Partnership)
- Eight Roads Dream Incubator Inc.
- DBJ Capital Co.,Ltd
- Integral Corporation
- Globis Capital Partners

Other VC/PE firm names
withheld.

ABOUT QODEOVIEW MARKET SNAPSHOT REPORTS

qodeoview market snapshots are reports written by qodeo-MBA researchers from 30 leading Business School alliance members about key venture/private equity and entrepreneurial trends and markets. These cover EMEA, North America & Asia. Insights gleaned are used by qodeo's investor:entrepreneur matching service and to assist corporate advisors build related pipelines.

Register at www.qodeo.com to receive these as part of our service.

MATCHING INVESTORS WITH ENTREPRENEURS

Qodeo monitors the venture ecosystem, identifies the best opportunities automatically, and brings entrepreneurs, investors and corporate advisors together to make it work. Acting as what one leading VC called "noise cancellation" for the global venture community, this is a brand new service for a new generation of entrepreneurs and investors who expect to be able to behave differently, and to do business differently.

qodeoview
JAPAN

A Private Equity & Venture Capital
industry market snapshot

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