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Continuity and Change in Japan's Ecosystem for Venture-Capital backed Start-up Companies: Encouraging the Creation of Firms to Stimulate Economic Growth and Jobs

Japan's business system has changed significantly since 2000, shifting toward increased labor mobility, greater emphasis on shareholder returns, more outsiders on corporate boards, and closer ties between firms and academia. An important subset of these broader changes is that leaders have overhauled laws and policies to create a healthy start-up ecosystem, especially in the Tokyo area.

A start-up ecosystem includes various laws, practices, actors (entrepreneurs, venture capitalists, bankers, lawyers), institutions (universities, firms, banks), and the relationships among them that impact the nation's capacity to create new firms as well as to shut down failing ones and reallocate their capital and human resources to new ventures. A healthy ecosystem has a virtuous cycle, in which entrepreneurs who create profitable businesses re-invest some of their profits and knowledge into new ventures, such that over time, successful start-ups sow the seeds of new successful ventures. The bigger the ecosystem, the better, but there at least needs to be a critical mass of experienced entrepreneurs, financiers, and support service providers.

Starting in the late 1990s, state and business leaders have significantly changed key parts of Japan's start-up ecosystem, including financing, reducing disincentives to entrepreneurship, encouraging a greater role of large firms and universities in the ecosystem, and creating state programs to educate, train, and mentor entrepreneurs. As a result, new firms are helping stimulate economic growth and provide new jobs.

Finance

New stock markets were created in the late 1990s that allow unprofitable firms to go public through an IPO. This increased options for entrepreneurs and investors to exit their investments. Various tax incentives for individual and corporate angels, created since the late 1990s, have become less cumbersome and are used more frequently.

Twenty years ago, most VC funding was a loan. Now virtually no VC is provided as a loan. Twenty years ago most VC companies were affiliated with risk-averse financial institutions, but only 60% of them are today. The rest of VC now comes from independent VC firms and Corporate Venture capital (CVC) funds of mainstream firms, such as Toyota, Mitsubishi, and NTT. The total amount of VC in Japan has rebounded from lows during the global financial crisis, reaching Japan's VC ¥152.9 billion yen ($1.4 billion) in 2016, which is quite small compared to the $69 billion in VC investment in the U.S. that year. Japan's VC investment is also relatively low as a percentage of GDP, but is not very different from that of France and Germany. Japanese VC investors are taking greater risk than in the past when they primarily invested in later stage firms; today most investment is in seed and early stage firms.

Reducing Barriers to Entrepreneurship

More people are thinking about becoming entrepreneurs in Japan, but social norms still work against such risk-taking. Most educated Japanese still prefer secure employment at a large firm, and low birth rates and few immigrants mean there are few young people to become entrepreneurs. The stigma against failure is lower than in the past, but is still comparatively strong. However, graduates of top universities can afford to fail because Rakuten and other young firms lacking rigid lifetime employment and seniority wage systems will hire them.

Other changes have reduced disincentives to entrepreneurship. Limited liability partnerships and companies have been permitted since the mid-2000s, allowing managers and investors to reduce the risk of being involved in start-ups, of which only 10% survive. Legal changes in the mid-2000s made bankruptcy much easier, quicker, and cheaper, thereby reducing barriers to entrepreneurship.

The practices of personal guarantees and stock buybacks, which have long discouraged entrepreneurship, have been dramatically improved. Until recently, most founders had to provide a personal guarantee for VC funding. But they are less common today because in 2014 Prime Minister Abe pressured banks to eliminate them. Banks opposed this change, so in the end guarantees became prohibited ‘in principle’, but with exceptions allowed. These exceptions are when the assets of founders and their firms are mixed, which is quite common in Japan. Still, due to Abe’s efforts, many entrepreneurs had their guarantees nullified and received new loans, some from government-owned banks, without needing to provide a guarantee.

Forced stock buybacks in which founders must buy back stock from a VC company at cost if an IPO doesn’t occur within a specified time frame or has a low payoff have also discouraged entrepreneurs. Powerful entrepreneurs can delete these buyback clauses from their contracts but most cannot. Recently entrepreneurs have collectively pushed back against major VC firms, and in some cases VC firms have accepted less than a full buyback.

Role of Large Firms and Universities

Large firms have traditionally practiced closed innovation within their *keiretsu*. But economic pressures have pushed them slowly toward open innovation, in which they collaborate with new firms and purchase their products. Large firms are also acquiring more ventures through M&A, rising from virtually no exits through acquisitions to 13% of venture exits in 2016. The possibility of exiting through acquisition opens up more opportunities for entrepreneurs and investors, and thus will likely increase entrepreneurs and VC investment. Large firms are also trying to speed up decision-making, and some are no longer regularly rotating managers involved in the VC world, allowing them to become VC specialists who can take on greater risks.

Legal reforms between 1998 and 2004 transformed the role of universities in the start-up ecosystem. They were allowed to establish technology licensing offices, which help professors obtain patents and handle the marketing and licensing of technology. Professors and universities can now own the results of state-funded research, and professors can earn extra compensation through consulting or creating new firms. As a result, universities are much more involved in creating start-ups.

The government is encouraging four national universities to play a greater role in the ecosystem by giving them about $1 billion dollars to invest in start-ups starting in 2015. There has been some criticism of the universities' investments because most goes to people they know, and much of the money has yet to be invested. But it is too early to make any definitive conclusions.

Other Government Programs

There are hundreds of other new government programs to train and support entrepreneurs. Unfortunately, most have small budgets and are housed in various ministries in a scattershot approach. It is too early to assess results, but in general experts praise the government for making key changes that have resulted in an ecosystem that is getting stronger and bigger day by day.

Conclusion

Japan's start-up ecosystem has helped many new firms emerge—from Rakuten, DeNA, and Gree, to Line and Mercari. And these new firms and their leaders have become angel investors, advisors, and mentors, who are now sowing the seeds of more successful ventures, triggering a virtuous cycle.

The government, entrepreneurs, and the VC industry have been the primary promoters of dramatic reforms, and big business and social norms have resisted change somewhat, making it relatively slow and incremental. It took Silicon Valley several decades to create a strong ecosystem and they received significant support from the defense industry. Only time will tell how successful Japan's ecosystem will be, but it has the fundamental ingredients to succeed and is comparable to other countries that started building ecosystems two decades ago, such as South Korea, Germany, and France. The efforts to create a healthy ecosystem signal Japan's successful attempt to shake off some of the shackles of its "coordinated market economy" and move more toward the institutions and policies of a "liberal market economy," at least in the area of venture-capital backed high-tech start-ups.