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Title: **Japanese Entrepreneurship and Opportunities for Partnering**

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Date: June 29, 1999

Abstract:

As part of the Japan Industry and Management of Technology (JIMT) Speaker Series, discusses the importance of entrepreneurship and new technologies in securing Japan's full economic recovery from the current economic slump. Describes the history of Japanese entrepreneurship, which experienced a golden age after WWII, and how the rise of large corporations led to less risk-taking, effectively stifling venture firms chances for success in the market. Discusses new government programs aimed at fostering venture firm growth and changes required in education, banking, mergers and acquisitions, the bankruptcy system and regional competition to support entrepreneurship. Describes current trends in small business and venture firms and the possibility for partnering with U.S. firms in collaborative research.

Keywords: entrepreneurship; high tech; small business; economic growth; research and development; trends; Japan

**IC<sup>2</sup> Institute Working Paper WP-1999-06-29**

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Opportunities for Partnering**

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IC<sup>2</sup> Institute – JIMT Series Working Paper  
June 29, 1999

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Working paper # 99-06-29

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# **Japanese Entrepreneurship and Opportunities for Partnering**

**Presented by Hidehiko Nishiyama**

Good evening, everyone. I am very happy to make my first visit to Austin and to have this opportunity to participate in the valuable JIMT Speaker Series. I understand that many people have been traveling to Austin recently. Even before the George W. phenomenon, however, Austin was an important destination for those interested in technology and the field of entrepreneurship and venture business. This, of course, is why I am here.

Like an increasing number of people in Japan – in government and business as well as private citizens – I firmly believe that entrepreneurs and the particular contributions they make are vital to Japan's success as a nation in the 21<sup>st</sup> century. And in the shorter term, I believe that entrepreneurs and new businesses can play an important role in securing Japan's full recovery from the current economic slump.

My basic message is that Japan has awakened to the importance of creating new businesses and new technology. While I don't underestimate the challenges that we face, I do feel there are grounds for optimism. The government has recently enacted wide-ranging measures to create a favorable environment and infrastructure, and encouraging developments are taking place on the local and regional level. Public attitudes are also undergoing positive changes. I will explain these developments in greater detail. But I would like to emphasize at the outset that an important goal for me on this visit is to exchange information with you and learn from your experience as a community and as individuals. As I will make clear later in my

remarks, I believe that learning from and cooperating with American counterparts in this area is especially timely and important.

First, some background. Venture business is not exactly a new phenomenon in Japan. In fact, the period right after the war was a kind of golden age for establishing new businesses in Japan, and they were an important factor in the nation's postwar economic recovery. Sony, which was founded in 1946, got its start repairing radios. After an unsuccessful attempt to market electric rice cookers, it found success with electric heating cushions and tape recorders. Honda, which was established two years later, initially refitted small auto engines on bicycles but eventually developed its own engines and became a successful manufacturer of motor scooters. At a time when existing institutions and organizations had collapsed, people did not hesitate to start small businesses or small ventures. It was, in fact, the only way to rebuild the nation.

The rapid economic growth that began in the 1950's and continued in the 1960's was due in large part to the vigor of such start-up firms, which became exporters of mass-produced products. In those days, no one doubted that the economy would continue to grow in the future, and companies steadily expanded their workforce to increase the scale of production. People became more likely to avoid the risks of start-up businesses and, instead, sought jobs in large companies, which looked as if they would keep expanding forever. Social conditions stabilized, and now that people were no longer forced to accept risks, they developed the habit of avoiding them. Since the economy continued to expand, both the public sector and the private companies were able to retain and support employees who didn't perform or contribute. While this satisfied people's preference for stability and security, it eventually led to a rigid society and economy.

Education reflected this change in social conditions. For students and their parents, the ultimate goal of education was to enter one of the elite universities that were the sole gateway to

prestigious large companies or the highly-regarded bureaucracy. Thus, the real goal of Japanese education, beginning in the early grades, was to give young people the ability to enter and survive in large institutions. Such a system was unlikely to produce people with the desire or the confidence to start up businesses.

Large corporations were revered as pillars of the national economy. In a society where failure was greatly feared, even venture firms offering good products and services had a hard time finding a place in the market. If a purchasing agent bought a product or service from a new small supplier and it happened to be defective, he would be criticized for not having selected a regular vendor or major company. This fear of criticism meant that few people dared to buy goods and services from venture firms.

Bankers also took this type of conservative, risk-averse approach. In general, they favored large, well-established companies as customers, and developed close relationships with them. When it came to financing newcomers, rather than evaluating the soundness of the business, they tended to insist on land as collateral and personal guarantees from the managers. Following the bursting of the land bubble economy in the early 90's and the explosive growth of bad debts due to falling land prices, personal guarantees have become even more central to conventional financing. As you can imagine, this has posed a real challenge to entrepreneurs.

Last year, in fact, the number of business start-ups in Japan was exceeded by business closures, and the rate of start-ups fell to one-third the US rate. Cyclical factors certainly played a role in this economic stagnation; but as I have mentioned, a major cause was the inability of Japan's economy and social structures to adapt to the new era. Now that the Japanese government's emergency measures to restructure the financial system and create demand are showing signs of success, a favorable environment is emerging for starting businesses with

original technology. I would like to emphasize that unless we seize this opportunity, Japan will be unable to maintain its current world position into the 21<sup>st</sup> century.

Original technology to boost competitiveness is needed in every sector, whether manufacturing, banking, or other service fields. I should mention that while there has been cooperation in technology development between manufacturers and government agencies in Japan, not enough attention has been paid to the kind of development efforts that look ahead five years or more. Nor have companies taken full advantage of the results of university-based research. In the service industries, greater efforts are needed to utilize the fruits of today's information and communications revolution. For their part, the banks need to move toward basing financing on a substantive analysis of the borrower's business operations and potential.

Now that the importance of new business creation and its relationship to new technology is widely acknowledged, the Japanese government is making intensive efforts to foster and favor this type of development. The list of new initiatives is a long one, and I only have time to mention some highlights:

- Since December of last year, the Japan Small Business Corporation has been helping to provide financing for entrepreneurs who want to turn their new ideas into businesses, or for prototype development that can be the basis for venture firms. In order to provide further assistance with credit for small and medium-sized firms, a special business credit insurance system has been set up, with a limit of 10 million yen, or about \$83,000.
- Government research and development funds are now being channeled to small businesses on a preferential basis. This is a Japanese version of the SBIR and it targets small- and medium-sized companies for investment.

- In January of last year, a financing system for persons who want to start a business in a field in which they have experience was set up in the form of no-collateral unsecured loans from the Citizen's Finance Corporation. And in October of the same year, financing became available for unemployed corporate managers who want to start businesses of their own. Moreover, this April, a system of low-interest financing was set up for women and elderly people who want to start businesses.
- If a company qualifies as a venture firm, it is now eligible for debt guarantees and investment from national and regional public funds. The government is also creating a system by which retirees from major corporations are sent as advisors to venture firms that lack managerial and technological know-how.
- Also in the area of funding, the Limited Partnership Act was set up in 1998 to make it easier for pension funds and others to supply funding to venture firms. The limited liability of partners who take no part in administration was confirmed, and the Act went into effect in November of last year. The ban on investment in ventures on the part of pension funds and securities investment trusts was lifted in 1997, so it is expected that this confirmation of limited liability will lead to further investment.
- A so-called "angel tax system" was introduced which permits individual investors in venture firms to carry over their losses for three years and write them off against stock transfer profits.
- To bring together prospective candidates for mergers and acquisitions, special venues called "M & A Plazas" were opened in major cities like Tokyo, Osaka, and Kobe.
- Since April 1998, venture companies have been able to use stock options to help attract superior employees, and 181 companies now offer them.

- To encourage the patenting of the results of university research and the distribution of this know-how to the industrial sector, support for a Technology Licensing Organization (TLO) was approved and put into effect in August 1998.

Thus the minimum necessary measures for directly aiding small businesses and venture firms have been put into place. Japan has a great deal of technology suitable for commercialization by venture firms. Companies and public research institutions are strongly aware of the importance of developing technology, and they have not let up their efforts, not even in the midst of recession. With these systems in place, if the societal changes I am about to discuss take hold, I believe that many companies will appear on the scene.

In considering the issue of changing society and how people think, it is difficult to exaggerate the significance of one key fact: The myth that large companies can guarantee security has been shattered. Most people who work for large companies are beginning to realize that they cannot count on such employers for a secure livelihood for the rest of their lives. If one family member experiences this, the others will soon start to have doubts about the traditional, large company-focused approach to education and job hunting. Parents, likewise, will put less value on education for their children that prepares them for large companies. Some, I am sure, will want their children to have the kind of education that will help them establish and succeed in the new companies that have a bright future. In the United States, over five hundred colleges and universities offer courses in entrepreneurship, as opposed to a mere thirty universities in Japan. This situation will probably change over time. At present, there is serious research going on in Japan about what kind of education is likely to foster an entrepreneurial spirit.

Since founding one's own business inevitably brings the possibility of failure, Japanese society will also have to adopt a more accommodating attitude toward failure. One topic now

under discussion is how to reform the bankruptcy system so as to provide systematic support to ease the recovery from failure. The most important thing is to create a system that enables effective use of failed management resources and rapid reorganization of corporate structures. We also need to create smoother links between the process of reorganization and mergers and acquisitions.

One reason that it is so difficult to recover from failure in Japan is that banks require personal guarantees from borrowers when providing financing. If entrepreneurs fail, they lose all their assets, except for the minimum amount needed for survival. So it is extremely difficult to get a second chance. However, the “big bang” reforms in the financial sector have greatly increased competition among banks – including foreign banks. Therefore, Japanese banks will have to learn how to do substantive evaluation of candidates for financing, rather than relying on personal guarantees. It is expected, incidentally, that Japanese banks will have to raise interest rates to cover possible losses in the new, more competitive environment.

Loans should not be the sole means of supplying capital to high-risk, high-return venture businesses: the flow of so-called direct financing, in the form of stock and corporate bonds, also needs to be activated. In order to make this possible, we need to promote rapid structural reform of the over-the-counter market. When they set out to start a company, most entrepreneurs hope to recover the investment capital through an IPO, mergers or acquisitions. However, Japan does not currently have the systems in place to meet this need. As of the end of 1997, the Japanese over-the-counter market had only one-seventh the number of companies as the American NASDAQ, and the amount bought and sold was only 1/100 of the amount on the NASDAQ.

This may change soon. MITI’s Over-the-Counter Study Group issued proposals for reform of the over-the-counter market in December 1997, and discussions about reform are

currently taking place on the basis of these proposals. Moreover, in an interesting development earlier this month, NASDAQ and Japan's Softbank Corporation announced that they would join forces to establish a sister version of the NASDAQ in Japan.

One other significant development I would like to mention is the energetic effort that Japan's outlying regions are now making to create a hospitable environment for small businesses and venture firms. Competition among regions, on one hand, and new types of cooperation among universities, companies, and public and private research institutions, on the other hand, are all positive trends. For example, the area around Tohoku University and its affiliated research institutes in Sendai (two hours northeast of Tokyo) has become a base for considerable private and public R & D on metals, electronics, and magnetic materials. In April of last year, Tohoku University founded the Future Science and Technology Center, which aims to develop new products and new technologies through cooperation between academia and industry. A private organization was established to promote commercialization of the results of this research, and in the spring of 1999, a major electronics manufacturer set up an incubator facility.

Japan's first independent graduate institute was founded at Ishikawa Science Park north of Kyoto to provide graduate education amidst world-class research work in the fields of advanced science and technology. The school is also carrying out cooperative research with private companies at a newly-established center.

What, then, is the actual state of Japan's small businesses and venture firms? According to a survey conducted at the end of September 1998, the total amount of investment by venture capitalists and limited partnerships was 729.9 billion yen – a 7% increase over the previous year, due to an increase in funding by limited partnerships. The number of companies receiving investments increased by 9.6% to 14,885 companies. Between April and September of 1998,

1,002 companies received investments. Despite the ongoing recession, therefore, the pace of investment has not slackened.

Japan has some small businesses that have attracted world-wide attention. For example, I-A-I Co., Ltd., a manufacturer of intelligent actuators, controls 45% of the world market. The firm has 2.8 billion yen in sales and 103 employees with an average age of 34. Arufa Given Co., Ltd. is the world's second largest manufacturer of quick-drying glue, with sales of 1.7 billion yen. Its products have been used in the space shuttle. Its 41 employees have an average age of 35. In addition, there is a company that was founded in 1988 and uses high-speed technology for printing color photographs. It now has 1000 retail outlets. Of course, these are merely a few examples of the whole range of Japan's small business.

Next, I would like to consider Japan's growing small business and venture sector from the viewpoint of relations with the United States. Let me say first of all that our small companies see American companies as important potential partners for collaborative research. As in the United States, the fastest growing Japanese companies are those involved in such fields as information technology and pharmaceuticals. While companies in the two countries, of course, compete with one another, there are also many cooperative relationships. For example, in the field of medical equipment manufacturing, a certain Japanese venture company has developed a laser technology that corrects nearsightedness, farsightedness, and astigmatism with a single device, and the group as a whole has had over 30 billion yen in sales. I understand that the founding of this company was motivated by a lecture that its president heard at an American university, and that the company has collaborated in research with American universities and companies.

Setting up exchanges between venture business-friendly regions of Japan and American centers of entrepreneurship and high tech – such as Austin – can help facilitate further cooperation between venture firms in our two countries. My own JETRO New York office has assisted in establishing this type of exchange between Tokyo's Tama area and Greater Washington, DC. Speaking of JETRO, I would like to mention that in addition to promoting region-to-region exchanges, we are also involved in facilitating technology transfer and tie-ups between American and Japanese companies. We maintain, for example, a database of Japanese companies interested in this area that can be accessed on the Web.

A second point is that America's infrastructure for fostering businesses can be a valuable resource for Japan's small businesses and venture firms. What I mean by infrastructure is the American venture capital, IPO, and M & A markets, and the extensive expertise that the US has in these areas. As I mentioned before, setting up this kind of infrastructure in Japan is a critical task, and we have already embarked on it. However, we can't expect Japan to develop an adequate infrastructure in a short time when the American infrastructure took such a long time to build. During this period, we may want to take advantage of America's infrastructure and know-how. From the point of view of the United States, this will expand the number of possibilities for investment in Japanese companies. For its part, Japan has made it clear that it welcomes foreign investment. This point was confirmed during top-level talks between Prime Minister Obuchi and President Clinton at the beginning of May. The kind of exchanges between Japanese and American venture firms that I have mentioned require efficient distribution of information, and JETRO is willing to do its part to make this happen.

As I noted earlier, Japanese entrepreneurship played only a minor role as long as Japan's economy maintained its high performance. However, now that we need economic structural

reform and the revitalizing effects that venture businesses can provide, we strongly hope that entrepreneurs will once again emerge. Japan clearly has a reservoir of the kind of technology that can provide the basis for entrepreneurship, and much work has been done recently to create an environment that is hospitable to venture business. I believe that if Japan can learn from America's wealth of experience in entrepreneurship and the United States can take advantage of Japanese technology to maintain sustainable growth, both countries can help each other prosper in the 21<sup>st</sup> century.

Thank you very much. I look forward to hearing your comments and responding to your questions.