Angel Investment in Japan

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In the United States, the amount of loans by angel investors to venture businesses is reported to be several times greater than equity investment by accredited venture capital companies. Nor is the role of angel investors solely that of providing capital: they can also offer companies a wealth of management expertise and exert considerable influence—especially when a company is being established. In Japan, there is also a law to help entrepreneurs set up venture businesses (Law to Encourage the Formation of Small and Medium Business Enterprises) and special tax provisions to encourage individual investors to invest in them. However, the system has not worked as well as it might. This report looks at some of the challenges facing angel investment in Japan and suggests some possible solutions, drawing on lessons that can be learnt from the US system.

1. Establishing a Company in Japan

1) Finance available to start-ups

The average cost of establishing a company in Japan is ¥15.37 million.[1] Roughly 30% of this is equity, the rest debt. Most of the debt consists of loans from financial institutions as access to risk capital is limited.

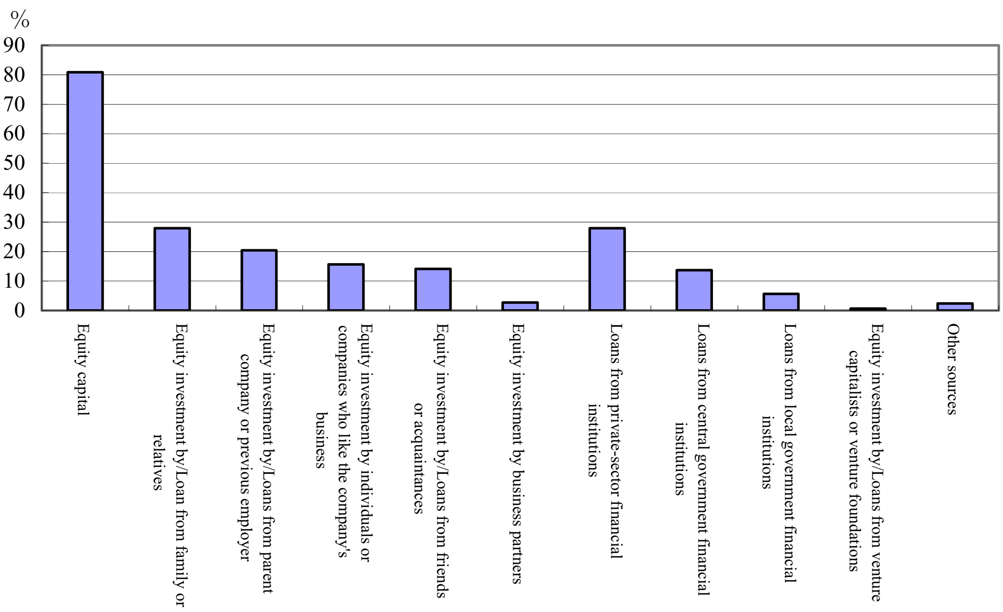
Younger entrepreneurs are particularly critical of the fact that the reliance of loan officers on collateral and managerial experience as the criteria for deciding whether to grant a loan is a major obstacle to start-ups in search of capital.

1 "2000nendo Shinki Kaigyo Jittai Chosa" [Survey of New Business Formations, Fiscal 2000], National Life Finance Corporation Research Institute.

Figure 1 Survey of Start-Up Conditions

Source: NRI, from "Sogyo Kankyo ni Kansuru Jittai Chosa" [Survey of Start-Up Conditions], Small and Medium Enterprises Agency, December 2001.

Figure 2 Sources of Start-Up Finance



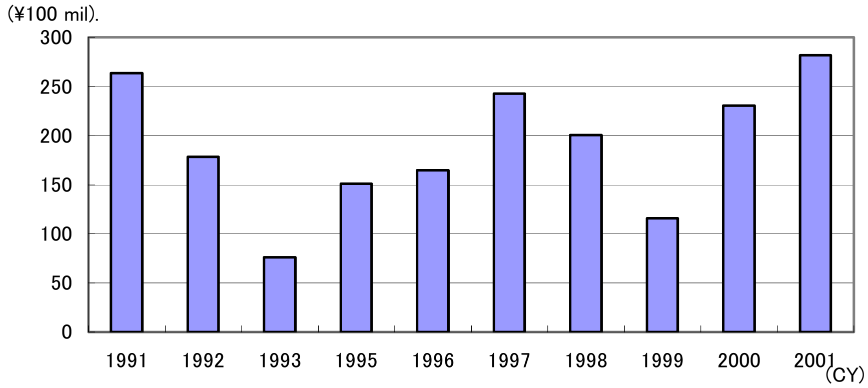
Note: Multiple responses mean that the total is more than 100%.
Source: NRI, from "Sogyo Kankyo ni Kansuru Jittai Chosa" [Survey of Start-Up Conditions], Small and Medium Enterprises Agency, December 2001.

2) Venture capital finance

Annual figures for venture capital finance in Japan show considerable variation (see Figure 3). The reason for this would appear to be the fact that the main investment objective of Japanese venture capitalists is the pursuit of an immediate return from a listing—an objective that is sensitive to developments on the stock market.

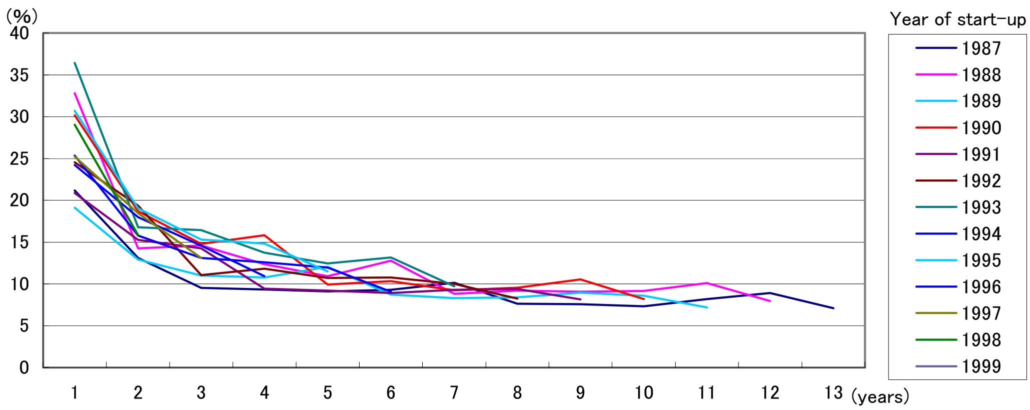
Nearly 30% of Japanese start-ups fail during their first 12 months. The main reason for this would appear to be not the effects of the business cycle but a dearth of financing opportunities and the experience needed to adapt to changing business conditions. However, in Japan, most venture capital companies, which are supposed to be the main source of risk capital for start-ups, do not invest in them until they are in the later stages of their development. In fact, less than 1% of their investments are made during the initial stages—hardly a very satisfactory state of affairs and one which suggests that the system of angel investment, which serves as a source of both capital and managerial expertise to start-ups in Europe and the United States, could also play an important role in Japan.

Figure 3 Annual Equity Investment by and Loans from Venture Capitalists



Source: NRI, from Venture Enterprise Center data.

Figure 4 Number of Years between Start-Up and Closure of New Manufacturing Businesses



Source: NRI, from Japan's Small and Medium Enterprises Agency's White Paper for 2002.

2. Angel Investment in the United States

1) "Angel investors"

The US Annual Report on Small Business and Competition ("The State of Small Business: A Report of the President") defines "angel investors" as "providers of risk capital other than accredited venture capitalists, equity stakeholders in small businesses, and institutional investors." In many cases, they are wealthy people who have acquired their investment and managerial expertise by running their own businesses. Also, they tend to limit their investments to areas within a 50-mile radius of their offices and homes.

In addition, they tend to invest at an earlier stage of a company's development than venture capitalists and are a recognized source of advice as well as capital to start-ups.

2) Networks linking entrepreneurs and angel investors

In 1996 the Federal Government in the United States created a network that links entrepreneurs and angel investors: the Angel Capital Network (or ACE-Net). Sponsored by the Small Business Administration, the system is run by 38 local operators working with local university and state business support centers. The system posts investment proposals on the Internet and is intended to enable investors and entrepreneurs in the process of starting up their own companies to match their financial needs quickly and cost-effectively.

Typically, the amount of investment capital provided by angel investors ranges between $250,000 and $5 million—less than the $10 million usually provided by venture capitalists. Angel investors, as defined by the Securities and Exchange Commission, also have to be "accredited investors."[2] In the case of individuals, this means any natural person with a net worth in excess of $1 million or an annual income in excess of $200,000.

As a result of the fact that entrepreneurs have to provide considerable information about their business plan when they register with ACE-Net and the fact that the process is both time-consuming and expensive, fewer companies registered than had initially been expected. The registration process was therefore simplified so that start-ups requiring no more than $1 million in investment capital could register using a simple form.

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2 As defined by Rule 501(a) of Regulation D.

The system allows investors to search for companies on the basis of factors such as market/technology, investment size, and stage of company development. If they find a match, they can access further particulars about the company concerned from the database. The service simply enables investors to query the company database: the system is passive and does not attempt to match the needs of entrepreneurs with those of investors in a more pro-active way.

Alongside this network there are a large number of private-sector angel networks. These originated with the incubator concept and the desire by some investors to reinvest more in their local areas. The incubator concept originated with programs to train entrepreneurs and was intended to help start-ups develop and to encourage local investors to fund entrepreneurs in need of assistance. As the system developed, universities and not-for-profit organizations became involved, and forums and conferences were held to bring together entrepreneurs and investors in one place. As such events became more commonplace, clubs were formed for venture capital investment. These functioned as informal networks that respected the privacy of their members while publishing details of their activities and facilitating the exchange of information with other organizations. As a result, contacts between clubs improved, leading to the formation of a large private-sector network.

A comparison of ACE-Net, which is a public-sector network, with the private-sector networks shows that some 800 investors were registered with ACE-Net at the beginning of 1999—more than the 100-200 investors permanently registered with the Technology Capital Network at MIT (TCN), a private-sector network. The fact that ACE-Net has more registered investors than a network such as TCN, in spite of the latter's favorable location and long history (since 1984), should help to ensure that the policy of setting up public networks is successful.

However, the fact that most of the investors that use ACE-Net are institutions and that the network has been relatively underused since the Internet bubble burst in 2000, bringing an end to the boom in initial public offerings, suggests that it has yet to become the kind of pro-active public network, linking individual investors and entrepreneurs, that angel investors would like.

3) Tax concessions for angel investors

US tax law grants concessions to anyone investing in small businesses that meet certain criteria. Any income from investments in such "S-Corporations,"[3] as they are called, is distributed to shareholders in proportion to the size of their equity stakes and

3 In order to qualify as an S-Corporation, a company must be owned by individuals resident in the United States or by a trust which itself is owned by such individuals. Similarly, the number of shareholders must not exceed 35.

is subject to personal (rather than corporate) income tax. Therefore, such investors' taxable income will rise if the companies concerned make a profit, and decline if they make a loss. In the latter case, investors can offset such losses against other income. This encourages individual investors to take the risk of investing in start-ups, which tend to make a loss before they make a profit.

Similarly, losses from the sale of a small business[4] can be offset against other personal income if the company concerned is less than a certain size. The maximum such loss that an investor who has acquired shares either from an initial public offering or a capital increase can offset is $50,000.[5]

These tax concessions for individual investors in small businesses, whether they remain shareholders or dispose of their shareholdings, limit their possible losses during a period when such investment is highly risky.

3. Official Assistance for Start-Ups in Japan

1) Background to the Law to Encourage the Formation of Small and Medium Business Enterprises

The Law to Encourage the Formation of Small and Medium Business Enterprises was passed in 1995 to offer assistance to small businesses during their early years and with research and development. The hope was that, by helping such businesses to be creative and innovative, the Law would also help Japanese industry to adapt and the Japanese economy to develop in a positive direction.

Companies that are "creative" will enter new fields of business and carry out R&D that will enable them to produce new goods and services. The Law's tax provisions and financing options are just part of a wide range of instruments now available to Japan's Small and Medium Enterprises Agency, working in cooperation with the prefectural authorities, to enable it to help the country's small businesses to be creative.

When the Law was amended in 1997, tax provisions for angel investors were incorporated to add to the equity financing options available to start-ups, while in

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4 For a company to qualify, (1) it must be a US-based company with a combined paid-up capital and surplus of not more than $1 million, and (2) its combined royalties, rents, dividends, interest and gains from the sale of securities must not exceed 50% of its total income during the five fiscal years preceding the year in which the loss from the sale of its shares was incurred.

5 Or $100,000 if a married couple file a joint tax return.

2000 this was extended to enable start-ups to raise the capital they needed for R&D and to recruit staff more easily by offering them stock options.

2) The Law's applications

The Law applies specifically to (1) small businesses established within the past five years that are involved in manufacturing, printing, software development and data processing; (2) small businesses that spend the equivalent of more than 3% of their sales on testing and research; and (3) small businesses established within the past five years that spend the equivalent of more than 3% of their sales on "testing and research, etc." (this includes the cost of introducing new technology and new business structures or developing new markets or businesses) or small businesses established within the past 10 years that spend the equivalent of more than 5% of their sales on this.

The first category of company is eligible for "start-up assistance," the second and third are eligible for "assistance for small businesses actively engaged in R&D and the commercialization of new ideas." Similarly, while the first two categories are eligible for tax reductions on capital investment and subject to special provisions of the SBIC Law,[6] the third is eligible for assistance in the form of tax concessions for angel investors.

3) Japanese system of taxing angel investors

The tax concessions for which companies in the third category above[7] are specifically eligible affect gains and losses on the transfer of shares in such companies. In order to be eligible, investors must have either signed an investment agreement with the companies concerned or acquired their shares in the course of a capital increase. If they hold those shares for more than three years and sell them within 12 months of their being listed, they are exempt from tax on a quarter of any capital gain and can carry forward any loss for three years.

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[6] The assistance is provided by the Small and Medium Business Investment Consultation Company (SBIC), which underwrites the issue of shares by start-ups. However, there are special provisions for companies with a paid-up capital of not more than ¥300 million in cases where this is allowed by a prefectural governor under the Law to Encourage the Formation of Small and Medium Business Enterprises.

[7] Further conditions are (1) that the company concerned must not be a subsidiary of a large company, (2) that at least one third of its shares must be owned by outsiders, and (3) that the company must be unlisted.

In addition, since 1 April 2002, these concessions, for which until then only individual investors were eligible, have been extended to certain types of investment partnerships[8] that have acquired their shares in the course of a capital increase.

4. Taxation Issues

Since this system of taxing angel investors was introduced in Japan five years ago, it has only been used 220 times.[9]

There are two possible explanations for this: one has to do with the issue of deciding which small businesses actually qualify; the other has to do with the scope of the tax concessions. A further issue is the need to revise the system governing private placements.

One of the criteria for determining which small businesses qualify for angel investment under the Law to Encourage the Formation of Small and Medium Business Enterprises is the proportion of sales that is spent on "testing and research, etc." If we consider the system of angel investment in the United States, however, it is debatable whether there is any need for the kind of approval system used in Japan. As we saw above, the only criteria in the United States for deciding whether a company qualifies as an angel investment are those (such as size and organization) for an S-Corporation. Extending the range of companies that satisfy these criteria has the effect of extending the scope for angel investment.

At the same time, restricting the criteria of eligibility for the individual investors who may use networks such as ACE-Net encourages participation by those with experience of risky investments and the assets to back such investments. Therefore even without making "growth" one of the criteria of eligibility for angel investments, ensuring that investors are motivated by profit will automatically ensure that capital is allocated to growth companies and that their performance is monitored by experienced investors. Such a system works perfectly well without the need for eligibility criteria at the point of entry and suggests that the Japanese system of eligibility for small businesses wishing to be candidates for angel investment needs to be re-examined.

8 Voluntary partnerships and limited investment partnerships. Silent partnerships and nonpersonal corporations are excluded.
9 The total investment involved was about ¥400 million.

Furthermore, although tax concessions for investments in venture businesses help to offset some of the considerable risk involved, tax concessions in Japan apply only if angel investors sell their shareholdings. As they apply only to the outcome of an investment, their effectiveness in attracting investment in the first place is limited. In the United States, where the average period of investment in a venture business is apparently eight years, similar tax concessions allowing investors to include gains and losses in their personal income apply throughout the period of an investment—not just at the point of sale. This is something lacking in Japan's system of tax concessions.

Another issue is the need to appeal to a wider range of investors—for example, by re-examining the general use of private placements to raise capital for venture businesses.

When venture businesses issue securities, they normally do so by means of private placements, which do not require them to publish documents such as securities reports and prospectuses. However, it has been proposed[10] that the system of "institutional private placements,"[11] the use of which is currently limited to bonds, should be extended to cover the issue of equities by venture businesses in addition to the existing system of issuing "small number private placements."[12] This proposal takes the view that, in order to create an effective system of private placement for venture business securities, more attention needs to be paid to the needs of different categories of investor and that accredited institutions in particular, which have a high degree of risk tolerance and adhere to the "buyer beware" principle, do not need to be protected by risk disclosure requirements and should be allowed to buy and sell securities by private treaty.

Similarly, the fact that issues of small number private placements depend on the number of investors who subscribe to an issue over a fixed period[13] means that they may not be flexible enough to enable companies to raise capital in emergencies and may even make it more difficult for rapidly-growing companies to raise capital as often as they would like.

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10 In an interim report published on 3 July 2002 by the Industrial and Financial Subcommittee of the Ministry of Economy, Trade and Industry's Industrial Structure Council.

11 "Institutional private placements" involve accredited institutional investors considered unlikely to transfer their shares to noninstitutional investors.

12 "Small number private placements" involve fewer than 50 investors considered unlikely to transfer their shares to other investors.

13 The number requirement for issues of restricted securities extends over a period of six months. In other words, a placement is considered to have taken place if at least 50 investors are involved over a period of six months.

It will also become increasingly necessary to distinguish between private placements and other types of intermediation. For example, if the activity of operating an angel network is regarded as the same as offering private placements, such intermediaries will have to register as engaged in securities business, and this may act as a deterrent. The authorities will therefore need to make it clear to operators of angel networks that they will not have to register as securities intermediaries if it is obvious that their systems and services are not being used to trade securities.

The authorities therefore need to ensure that the regulatory system does not become so inflexible that it deters experienced investors who are not averse to risk as such investment is essential to venture businesses, without which any regeneration of Japanese industry is impossible.