Encouraging the Supply of Risk Capital by Financial Institutions

to Support Business Start-Ups and New Businesses

Public-Private Financial Roundtable

Improvement in Financing for Small Businesses

Task Force

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Introduction

The "Working Group on the Medium- and Long-Term Modalities of the Japanese Financial Industry" (Financial System Council, Financial Services Agency) published a report "The Japanese Financial Industry: Desirable State in the Medium- and Long-Term (Present State and Future Outlook)" (May 28, 2012). In that report, it was proposed to form a "public-private financial roundtable" where regular discussions would be held between the finance industry and relevant authorities to share the same problems and goals regarding the role of the finance industry in Japan from a medium- to long-term perspective and to work together to achieve those goals.

In accordance with that proposal, the "Public-Private Financial Roundtable" was formed. In its first meeting on September 25, 2012, it was agreed that ad hoc task forces should be formed to have free and vigorous discussions on the following three subjects between business professionals from both the public and the private sectors:

(1) Expanding the global businesses of Japanese enterprises and financial institutions

(2) Improving financing for small businesses

(3) Improving financial services to support the aging society

This Task Force was formed to discuss Point (2) above, specifically, matters that need to be tackled by both the public sector and the private sector to support business start-ups and new businesses, including encouraging the supply of risk capital by financial institutions.

(Approaches)

Since October 2012, this Task Force, comprised of business professionals recommended by member organizations, has met at a frequency of about twice a month to have free and vigorous discussions, including presentations from those business professionals and outside experts.

The participating member organizations and professionals are:

The Japanese Bankers Association, the Regional Banks Association of Japan, the Second Association of Regional Banks, the National Association of Shinkin Banks, the National Central Society of Credit Cooperatives, the Japan Securities Dealers Association, the Life Insurance Association of Japan, the General Insurance Association of Japan, Norinchukin Bank, the Development Bank of Japan, the Japan Finance Corporation, the Bank of Japan, the Organization for Small & Medium Sized Enterprises and Regional Innovation (Ministry of Internal Affairs and Communications), the Small and Medium Enterprise Agency, Mr. Arito Ono (Mizuho Research Institute Ltd.) and the Financial Services Agency (as coordinator).

We would like to express our gratitude to the following outside experts who presented their opinions regarding individual subjects (in alphabetical order, titles omitted):

Mr. GOJI, Tomotaka (The University of Tokyo Edge Capital Co., Ltd.)
Mr. HAYAKWA, Hiroshi (Japan Association of Corporate Executives)
Mr. KONUMA, Yasuyuki (Tokyo Stock Exchange, Inc.)
Mr. OSAWA, Ryuichi (Nomura Research and Advisory Co., Ltd.)

In the first to third meetings, the Task Force identified the following issues to be discussed and from the fourth meeting, they discussed individual issues.

1. Improving discernment capability
2. Sharing know-how
3. Proper risk-sharing
4. Improving the hands-on support capability of financial institutions
5. Involvement of institutional investors
6. Diversifying investment exits
7. Involvement of governments (discussion on collaboration between local public organizations and financial institutions)

This report summarizes the results of these discussions.

Please note that "future direction" statements included in this report should be read as a "preliminary report" that presents general opinions expressed in the free discussions so that as many proposals as possible can be incorporated, that all participants in the meetings did not necessarily agree with all of these opinions, and that none of these statements are binding on any parties involved in the discussions. However, we anticipate that further in-depth discussions will take place among the parties concerned, which we believe will lead to even more ideas being proposed.

1. Improving discernment capability

<Awareness>

(1) Actions to improve financial institutions' discernment capability

When providing support for business start-ups and new businesses, financial institutions need adequate discernment capability to evaluate the business value of enterprises that have been operated for some time, as well as their future potential. In addition to this general discernment capability, they also need the ability to evaluate enterprises from more comprehensive perspectives, including the potential of the commercialization of new technologies, and analysis of investment risk/return before stable cash flows are generated.

However, there is a limit to how far these comprehensive needs can be satisfied by individual financial institutions or their investment subsidiaries (hereinafter referred to collectively as "financial institutions"). As explained below, we believe that collaboration with outside experts will become important.

(2) Collaboration with outside experts (Establishing an information network)

Collaboration with outside experts should be very helpful for acquiring know-how that is otherwise difficult for individual financial institutions to acquire. In fact, in making investment decisions, including investments in venture businesses, many financial institutions seek advice from companies, universities, research and development organizations and other outside experts who have professional expertise and know-how.

Research and development activities conducted by venture businesses for commercialization often involve advanced and new technologies. It is difficult for financial institutions to retain within their own organizations experts who are knowledgeable about all such technologies. Finding experts who have the best knowledge and know-how in individual technical fields is the key to financial institutions being able to discern the suitability of prospective borrowers or investees.

When making a decision on investment in a venture business, the term "discernment capability" generally refers to the ability to evaluate whether a new project of the venture business can steadily grow into a profitable business and whether investments can be collected and maximum returns can be obtained from, for instance, the initial public offering (IPO) of the venture's stock, upon exit of the investment.

However, in addition to the ability to evaluate proposed investments in terms of financially reasonable returns and IPOs, the ability to assess other aspects, such as whether the proposed investments will help to increase local employment or otherwise vitalize the local economy in the medium to long term may also be important.

Accordingly, in addition to investment returns and IPO potential, the proposed investments' impact on other areas should also be discussed. When a fund is formed to promote vitalization of the local community, for example, it should be fully discussed how investments from the private sector can be attracted.

<Future Direction>

Individual financial institutions should independently take specific actions to improve their discernment capability, considering their sizes and characteristics. Actions to be taken by financial institutions to improve their discernment capability and investment sense may include:

- **Forming an investment department (separate from indirect financing);**
- **Developing the talent of employees by lengthening the job rotation span in the investment department;**
- **Transferring employees of financial institutions temporarily to investment companies (including financial institutions' subsidiaries or affiliates);**
- **Utilizing the training and education programs of outside professional organizations[1]; and**
- **Establishing a system for sharing successful experiences and know-how in the finance industry.**

Actions to promote collaboration between financial institutions and outside experts and to establish information networks may include:

- **Establishing a network that enables face-to-face acquisition of information that is generally difficult to be obtained by financial institutions, from experts in various fields, when making decisions on investments on venture businesses[2];**
- **Establishing a system to strengthen collaboration with the Japan Science and Technology Agency (JST), a public organization that provides aid for the new technology research and development activities of enterprises, the National Institute of Advanced Industrial Science and Technology (AIST), or municipal research laboratories;**
- **Utilizing local-based networks, regional Economy, Trade and Industry bureaus should carry out "evaluations of the business feasibility of technologies" of the new businesses or product development efforts of local small companies. Public support in collaboration with local financial institutions should be strengthened so that small companies can acquire the funds and sales channels necessary for commercialization of**

[1] It was recommended that the JVCA Capitalist Training Program provided by the Japan Venture Capital Association would be helpful.

[2] There was also the opinion that good personal connections would be established by lengthening the job rotation span in the investment department, as mentioned above.

their businesses.[3]

- **In collaboration with the Organization for Small & Medium Sized Enterprises and Regional Innovation**[4]**, local financial institutions that start funds designed to support business start-ups and new businesses in local communities should share the knowledge and know-how possessed by that Organization in order to improve their discernment capability.**
- **Local financial institutions should utilize the functions of the Regional Economy Vitalization Corporation of Japan**[5] **(hereinafter "REVIC”): (1) direct support for business revitalization, (2) strengthening the frontline of local revitalization and (3) support for vitalization of the local community. At the same time they must improve their own discernment capability by accumulating internally the knowledge and skills that they learn from experts in REVIC.**
- **The discernment capability of “angel” investors and their networks should be used effectively.**

2. Sharing know-how

<Awareness>

(1) Sharing know-how related to due diligence

Private financial institutions and government-affiliated financial institutions often provide joint support to a business start-up or new business project. In such a project that involves more than one investor, it is not very efficient for investors to exercise due diligence (evaluation of technologies, marketability, etc.) individually. Some mechanism to enable collaboration in this area is necessary.

(2) Sharing of know-how on fund evaluation

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[3] Such as “Evaluation of the Business Feasibility of Technologies” conducted by the Chugoku Industrial Cluster Committee of Evaluation of Business Feasibility of Technologies (comprising members from the Chugoku Industrial Innovation Center, the Chugoku New Business Conference, and the Chugoku Bureau of Economy, Trade and Industry)

[4] In meetings of the fund investment committees of its investees, representatives from the Organization for Small & Medium Enterprises and Regional Innovation attended as observers and presented their opinions and provided details of some of the organization’s successful fund investments.

[5] The former Enterprise Turnaround Initiative Corporation of Japan (“ETIC”) was totally reorganized as REVIC. The new organization started operations in March 2013. In addition to support provided by ETIC for restructuring of individual enterprises, REVIC will operate local vitalization funds and dispatch experts to local financial institutions.

When a financial institution forms a venture fund or the like in collaboration with a fund management company for supplying risk capital to venture businesses, or when a financial institution considers investment in a fund as a limited partner, it is beneficial to share not only know-how related to investment decisions on individual projects but also comprehensive information and know-how.

(3) Utilizing the Regional Economy Vitalization Corporation of Japan

The REVIC started operations in March 2013 and plans operate funds intended for local vitalization and dispatch experts to fund operators and local financial institutions. When providing support for the formation of new companies or commencement of new businesses, financial institutions are expected to utilize these functions of REVIC effectively, by sharing the information and know-how possessed by REVIC in evaluating the future potential of a business and other factors.

<Future Direction>

- **Government-affiliated financial institutions have due diligence know-how. An approach should be discussed in which they disclose the results of their due diligence to private financial institutions.[6] Creation of uniform templates should be considered so that confidential information such as the results of due diligence on individual enterprises can be effectively and property disclosed and shared.**
- **A system to share know-how on due diligence performed by government-affiliated financial institutions should be developed to provide incentives to private financial institutions for actively proposing individual investments.**
- **The Organization for Small and Medium-sized Enterprises and Regional Innovation (SMRJ) and government-affiliated financial institutions have much experience of collaboration with many funds. When a financial institution forms a venture fund or invests in a venture fund in collaboration with a fund management company, a system would be necessary in which the financial institution can contact SMRJ or a government-affiliated financial institution to share information and know-how on the evaluation of the performance of the fund management company and its investment trend.[7]**

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6 To realize this approach, the prior consent of client companies is necessary.

7 It would be more beneficial for the entire finance industry to cooperate with these government organizations via a trade organization rather than by individual financial institutions establishing separate information/know-how

- **Financial institutions should actively utilize REVIC and local vitalization funds, strengthen collaboration among related parties to provide effective support to local enterprises by using the information network and know-how of REVIC.**
- **“Regional roundtables” should be established to host ongoing discussions among private financial institutions, government-affiliated financial institutions and local governments, and leading local enterprises as needed, regarding support for business start-ups and new businesses and general matters related to local vitalization.[8]**

3. Proper risk-sharing

<Awareness>

(1) Collaboration to mitigate risks

The growth stages of venture businesses are often divided into (1) Seed (preparation), (2) Start-up (formation), (3) Early, (4) Middle and (5) Late.[9] It is often difficult for a venture business to obtain the funds necessary to continue until it grows into a profitable operation after the formation of the company (i.e. Stages (2) to (4)). Accordingly, these stages are often called “Death Valley” because an enterprise has a high risk of being short of funds.

Including this Death Valley period, it is a very important task for financial institutions to provide solid financial and other support to these new enterprises that have not yet reached profitability. However, in these early stages after the business start-up, there is a great deal of uncertainty about whether they will be successful, and they have limited assets that can be offered as collateral. Accordingly, financial support for these enterprises involves higher risks for financial institutions than usual lending. Therefore, it is highly necessary to consider how risks could be shared effectively among related players, including government agencies.

To share the risks effectively, financial institutions and other players should cooperate with each other and assume their respective roles. A system to share risks among the players according to the growth stage of an enterprise should be developed.

In the above-mentioned five stages, it is difficult for a venture business to generate stable cash flow in Stages (1) to (3). Accordingly, most enterprises at these stages seek equity funds (such as capital subscription or subordinated funds) rather than debt funds (loans) that generally

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systems.

[8] To establish this system, the Small Business Support Network which was completed in the end of 2012 covering 47 prefectures, and other similar networks may be also utilized, in addition to local vitalization funds.

[9] “Expansion” or “Growth” are also used instead of “Middle” in some documents.

need scheduled repayments.

As providers of these funds, government-affiliated financial institutions or venture funds are more appropriate than private financial institutions that obtain funds mainly from deposits. However, private financial institutions can also establish a system to supply equity funds for Seed or Early stage enterprises, by collaborating with outside experts and utilizing subsidiaries engaged exclusively in providing investment funding.

(2) Risk sharing in loans for business start-ups

As measures for sharing the risks related to financing for business start-ups, business start-up credit guarantee programs provided by credit guarantee associations and business start-up loans provided by Japan Finance Corporation ("JFC") may be utilized. These programs provide financial support to those who need equipment funds and operating funds for starting up and operating new businesses. The total limit for the business start-up credit guarantee programs is ¥25 million (no security required) and the limit for the JFC business start-up loan is ¥72 million (including ¥15 million without security or guarantee).[10]

Any person who plans to start a new business or who started a business up to five years earlier is eligible for these programs, in principle. It is difficult for those who do not have a past business record or assets that can be offered as collateral to obtain credit from a financial institution. These programs are intended to support the small business start-ups of such people by providing credit guarantees or direct financing by public organizations, on the condition that they present a concrete future business plan. By using these programs, founders of small businesses can secure the funds necessary for successfully starting their businesses.

Many business start-up credit guarantee programs provide full guarantees (100%) by credit guarantee associations. The use of "risk sharing" credit guarantee programs in which private financial institutions share a portion of the risk[11] is limited. It is a burden for a private financial institution to bear the whole risk of providing loans for business start-ups. Accordingly, full guarantees by credit guarantee associations work to encourage active financial support for business start-ups by private financial institutions.

As explained above, the total limit for the credit guarantee is ¥25 million for each business

[10] The limit for the "business start-up guarantee" is ¥10 million, and the limit for the "business start-up and split-up is ¥15 million, totaling ¥25 million.

[11] A program in which a credit guarantee association provides a guarantee for 80% of a loan provided by a financial institution, with the financial institution assuming the risk for the remaining 20%. The purpose of this program is to share risks properly and promote cooperation between a credit guarantee association and a financial institution to continuously monitor the business motivation of small business operators while providing proper support to small businesses, including loans and subsequent business support and support for rehabilitation.

start-up, which is not very large. Therefore, even if a portion of the risk associated with a start-up loan is assumed by a private financial institution, the burden is not very large.

The business start-up loan provided by JFC, which is used by about 20,000 enterprises (about 20% of all business start-ups) each year, plays an important role in encouraging business start-ups. To further strengthen financial support for business start-ups, the collaboration between private financial institutions and JFC should be strengthened, including syndicated loans, and the associated risks should be shared between them.

(3) Sharing the risks associated with business succession

In local communities, owners of small businesses are getting older. Many small businesses face the problem of not having a successor in their families despite the fact that they can continue the businesses profitably. In addition to support for business start-ups and new business operations, it is also important to provide support for business succession for these enterprises, in order to maintain and promote the growth of local economies.

If small business owners cannot find a successor from among their family members, they must find a successor from among the company's officers or employees. Currently, a government-affiliated financial institution provides certain loan programs to satisfy this need.[12] However, such support is just supplementary and does not cover all needs. To provide comprehensive support to these small enterprises, similar types of loans also need to be provided by private financial institutions. However, because such successor candidates (i.e. employees or other individuals) often do not have sufficient assets of their own to secure a loan, it is difficult for them to obtain loans from private financial institutions.

<Future Direction>

- **A system should be considered in which lenders collaborate with each other with appropriate timing according to the growth stages of an enterprise; in the early stages with relatively high risk, government-affiliated financial institutions should provide equity funds to venture businesses. Once the business of an enterprise gets on a growth track, private financial institutions should provide loans to supply operating funds and additional funds to purchase equipment.**

[12] If an enterprise is approved to be eligible to receive benefits under the Business Succession Promotion Act and the successor candidate (an individual) purchases shares or operating assets of that enterprise, or if a company or other entity takes over, by business assignment or M&A, a small business that finds it difficult to continue because it cannot find a successor, such successor candidate or succeeding company may obtain a loan with a low interest rate from JFC.

- **Collaboration between government-affiliated and private financial institutions should be further strengthened, with loans for enterprises in the start-up stage, and equity loans and other facilities provided by government-affiliated financial institutions.**
- **Collaborative relationships between private and government-affiliated financial institutions, or between private financial institutions and venture funds should be established to realize the above-mentioned collaboration. In addition, meetings should be conducted to discuss various collaborations on the frontline, organizational level and industrial level.**
- **A system should be established in which a private financial institution, after discovering an entrepreneur through its daily business activities, may refer that entrepreneur to a venture fund; risks at the initial stage would be assumed by the venture fund; and then the referring financial institution should receive the first right to negotiate with that entrepreneur once his business grows and becomes eligible for loans.**[13]
- **More effective risk sharing among lenders of start-up funds is needed and the screening capability of financial institutions should be improved. To achieve these, for instance, in credit guarantee systems, (1) modes of start-up credit guarantees should be diversified (such as full guarantees and risk-sharing guarantees, which are presently provided, and combination of these arrangements with proprietary loans provided by individual financial institutions), and (2) the parties concerned should discuss and share their understanding of the purpose and actual use status of the guarantee system, including what role individual players should assume for supporting businesses that require government approval.**[14]
- **The parties concerned should have discussions regarding establishing a system to share the risks involved in providing funds to employees or other individuals who are successors of small businesses.**

4. Improving the hands-on support capability of financial institutions

<Awareness>

[13] Once such a system is established, it should become an incentive for private financial institutions to explore for and foster entrepreneurs even if they do not immediately lead to loan transactions in the initial exploration stage.
[14] Credit guarantee programs require that certain businesses need to obtain prior governmental approval for business start-ups or have good prospect to obtain such government approval. There was an opinion that this requirement prevents active use of the guarantee programs.

(1) Effective use of information regarding support programs

Proper support needs to be provided at all life stages of an enterprise, including the Growth stage and the second start-up stage, not only the Seed stage and the Early stage. For example, high-value-added incubation facilities provided by local public organizations or the Organization for Small and Medium-sized Enterprises and Regional Innovation is a helpful support for Seed-stage enterprises. Support for participation in trade shows and exhibitions provided by the Japan External Trade Organization (JETRO) and the Export Support and Consultation Service (a consultation service provided by experts posted in foreign countries by JETRO) would be helpful for Growth-stage enterprises planning international business expansion. However, there was the opinion that information about these support programs is “complex and hard to understand” or that “different government agencies and support organizations provide information separately,” and thus, proper information does not reach the persons in need.

To solve this problem, a network should be established through which an entrepreneur can access all necessary information and resources from whichever organization he consults with.

(2) Measures to promote hands-on support by financial institutions

The opinion was expressed that, unlike support for existing customers, financial institutions may not recognize the necessity of active hands-on support for entrepreneurs with whom they have no transactions yet because the support given to such entrepreneurs does not have a direct impact on their business or may not necessarily lead to future loan transactions. However, financial institutions, especially local financial institutions, are very important resources for local economies and are expected to play a leading role in vitalizing local economies. Moreover, from the viewpoint of expanding the future customer base for financial institutions, it is very important for them to actively provide consultation and hands-on support to entrepreneurs and propose solutions for their problems. Because it is often difficult for financial institutions to satisfy the non-financial needs of entrepreneurs, they should actively cooperate with outside organizations to coordinate such non-financial support.

<Future Direction>

- **Financial institutions and other support organizations should more effectively use the support information published in the small business support website (J-net21[15])**

[15] http://j-net21.smrj.go.jp/index.html

operated by the Organization for Small and Medium-sized Enterprises and Regional Innovation, and other places.

- **For programs to support business start-ups and new business operations, a central information publishing system controlled by the government should be established so that information can be positively provided to individual entrepreneurs, small businesses and support organizations.**
- **All information on support programs provided by the different agencies and support organizations should be gathered and made available at each regional Economy, Trade and Industry bureau and other offices so that each branch office can provide proper consultation and advice directly to small businesses. A system in which such gathered information can be provided to each support organization (so that small businesses can obtain all necessary and correct information at one location) should be established.**[16]
- **Incentive programs to encourage hands-on support by financial institutions (such as programs to recognize such support activities more highly than ever, by providing an award, for example) should be implemented.**
- **For technological support, such as for improvement of production processes and new product development, about which financial institutions do not have advanced knowledge within their organizations, specialist dispatch services provided by the Organization for Small & Medium Enterprises and Regional Innovation and REVIC should be utilized.**[17]

5. Involvement of institutional investors

<Awareness>

(1) Involvement of institutional investors

[16] According to the White Paper on Small and Medium Enterprises in Japan 2011, many business owners replied to a survey that they first consult their tax accountants on any business issues they may face. Based on this survey result, it is necessary to include tax accountants and local commerce and industry associations, chambers of commerce and many other support organizations in the small business support information network, not only financial institutions in the forefront. Support from “authorized support organizations” under the Act on Enhancement and Support for Small Business Management may also be utilized.

[17] The Organization for Small and Medium-sized Enterprises and Regional Innovation has a network of professionals, comprised of about 1,300 experts, including retired executives of leading companies, lawyers, and accountants. Special teams of these professionals are formed to address various management issues, according to the business categories, business structures, market environments and growth/development stages of small businesses, and provide optimum advice for consulted problems.
REVIC will also dispatch experts to local financial institutions to provide the specialized knowledge that local financial institutions and local vitalization funds do not have.

Insurance companies (including venture subsidiaries and investment trust subsidiaries), pension funds and other institutional investors play an important role in providing support to business start-ups and new business operations, as leading suppliers of risk capital by investing in venture businesses and funds. In fact, some leading insurance companies have subsidiaries that are exclusively engaged in investment in venture businesses. By separating risks from the insurance business, and by concentrating specialists and know-how in these subsidiaries, they make investments and provide support to venture businesses.

Institutional investors who invest extensively nationwide have abundant funds and investment know-how. Their money and know-how should also be effectively utilized for exploring and developing promising business start-up projects in local communities. However, these institutional investors do not have much information on local-level projects. Moreover, it was pointed out that when a local fund is formed, participation by these institutional investors is often not anticipated in the first place.

These problems should be discussed among the parties concerned and resolved as much as possible so that the money and know-how of insurance companies, pension funds and other institutional investors are gathered and utilized effectively for supporting local business start-ups and new business operations, which, in turn, leads to the vitalization of local economies.

(2) Involvement of financial institutions (as investors)

Like institutional investors, many local financial institutions make investments in venture businesses via investment in venture funds or their specialized subsidiaries. Especially when forming a local fund, a fund management company (including a subsidiary/affiliate of a local financial institution) often serves as a general partner who assumes responsibility for the operation of the fund, while the local financial institution serves as a limited partner who provides cash to the fund.

Although various types of funds, including funds formed by private companies, are operated, many local financial institutions do not have abundant experience in investment in funds. Accordingly, it is necessary to implement measures to soften financial institutions' resistance toward fund investments and promote their active involvement, including investment as limited partners.[18]

[18] In addition to these measures, investors should be diversified and increased in number by inviting individual investors. At a meeting of this Task Force, as means to supply risk capital to support business start-ups and new business operations, it was proposed that funds designed for investment in small businesses by individual investors should be formed or that equities in these funds should be sold over the counter by financial institutions.

<Future Direction>

- **When forming a local fund, extensive efforts should be made to invite national-level institutional investors to participate. A system by which institutional investors can communicate their willingness to invest in local businesses should also be established.**
- **Institutional investors should be included in the collaboration among industry, academia, the financial industry and the government to find promising local businesses to invest in. Joint funds should also be formed with local financial institutions. Information on successful cases of businesses being fostered by local funds should be shared. The framework of "regional roundtables" may also be used for such collaboration.**
- **To make a correct decision on investment in a fund, it is necessary to be able to make a fair evaluation of the management abilities of the general partner and other conditions of the fund. Accordingly, a system should be established to share among related parties the objective information necessary for a fair evaluation, such as the outlines and investment performance records of individual investment companies involved.**
- **In collaboration with the Regional Economy Vitalization Corporation and other public support organizations, local financial institutions should actively provide support to local enterprises planning to start new businesses or transform their businesses, or to enterprises engaging in business activities that promote vitalization of the local economy.**
- **"Regional roundtables" should be utilized. Access to information about a fund, including information on general partners, should be improved to encourage active participation of local financial institutions, including participation as limited partners.**

6. Diversifying investment exits

<Awareness>

From the business start-up and until their cash flows stabilize, companies need equity funds that they do not need to repay. On the other hand, investors of course expect exits (returns on investment). A typical exit for an investment in a venture business is the sale of shares on the stock market by way of an initial public offering (IPO). However, to vitalize the local economy,

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However, there was also the opinion that over-the-counter sales by financial institutions need careful review from the viewpoint of providing necessary explanations to customers and avoiding possible conflicts of interest.

it is also important to foster locally-based companies that are not planning an IPO. While promoting IPOs, other modes of timely exits should also be provided for investments in businesses that are not planning an IPO in order to increase the supply of equity funds.

(1) Exit by way of IPO

At their peak, about 200 IPOs were launched each year. However, after the collapse of Lehman Brothers, the number dropped sharply to 19 IPOs in 2009. Subsequently, the number recovered to 48 IPOs in 2012 as a result of various efforts in the securities industry to promote IPOs. However, there is still room for more IPOs.[19]

To promote IPOs, first the motivation of business owners for listing should be strengthened. In a local community, it is said that once a symbolic IPO is realized, other IPOs may follow.[20] Accordingly, the spread of information and a feeling of momentum within a local community are important when promoting IPOs.

For example, the Tokyo Stock Exchange has revised listing examination standards and modified the examination period. In addition to these system revisions, it dispatches to each prefecture a contact person who provides consultation regarding IPOs, conducts seminars and events in various places and conducts other activities to encourage IPOs. Securities companies also look for IPO candidates in local communities.

Securities companies may conduct these activities effectively by collaborating with, and encouraging participation of local financial institutions that have a strong presence in local communities with an extensive network of branch offices and substantial information networks.

(2) Other exits than through IPOs

Exits from investments other than through an IPO may include (1) M&As, (2) Use of the Green Sheet Stock System, and (3) Buy-backs by business owners.

(1) M&A

If the current management team does not need to continue to control the company, an M&A may be an effective exit. However, one of the problems associated with an M&A is that it would be difficult for a buyer to acquire a majority of the equity of a venture business if different venture funds or financial institutions hold the equity, because each investor may have a different shareholding period. A solution to this problem may be use of a secondary fund.

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[19] The number of IPOs is based on research by the Tokyo Stock Exchange.

[20] After the IPO of Otsuka Holdings (established in the Shikoku region) in 2010, two IPOs were launched in Ehime in 2011 (PSC Inc., and Berg Earth Co., Ltd.), and one each in Tokushima and Ehime in 2012 (Awa Paper Mfg. Co., Ltd., and Arigato Service Co., Ltd.).

There was also the opinion that use of private brokers for an M&A is not suitable for small business because brokerage fees must be paid. To cope with this problem, use of a Business Succession Center, a public organization that provides support for M&As of small businesses, could be effective. However, there are only seven such centers throughout Japan. It was also opined that collaboration with financial institutions (especially local financial institutions) should be further strengthened in order to improve the closing rates of M&A deals because financial institutions are expected to serve as information sources regarding M&A needs.

(2) Use of the Green Sheet Stock System and TOKYO PRO market[21]

The Green Sheet Stock System is a method of trading of unlisted shares. The system was started in July 1997 by the Japan Securities Dealers Association in order to facilitate fair and smooth trading of unlisted shares. Because it is intended to facilitate fund raising by unlisted companies and create a liquid investment for investors, the system is operated with a different status from other exchange markets under the Financial Instruments and Exchange Act. At its peak, more than 20 companies were added to the system each year. However, because disclosure equivalent to listed companies is required, the number of registered companies has decreased to just 37 companies.[22]

In the future, parties concerned should verify the usefulness and problems of the Green Sheet Stock System to make improvements in the system beneficial to both companies and investors. By establishing a local framework for funding and by expanding the risk capital supply function, the Green Sheet Stock System should continue to play an important role.[23]

The TOKYO PRO Market is the only market for professional investors in Japan created by the Tokyo Stock Exchange. Although it is operated with very flexible standards, which are difficult to be adopted by existing exchanges where protection of general investors is strongly required, there are only three companies listed in this market as of March 2013.

(3) Buy-backs by business owners

Another exit mode for investors may be a buy-back of shares by business owners. Once the business of a company has gotten on track and the company has accumulated significant business profit (retained earnings), the operator of the company or the company that has issued shares may purchase its shares back from investors. The retained earnings of the company may

[21] Listing on the TOKYO PRO Market is also one type of IPO. However, because participants in this market are limited to professional investors, it should be treated separately from the conventional securities markets. Accordingly, it is included in this section.

[22] As of March 2013

[23] It should be noted that the Green Sheet Registration System puts more focus on facilitating supply of funds to unlisted companies rather than securing an exit for investors.

be used as a source of funds for the buy-back (including the lending of such retained earnings from the company to the business owner). And if more cash is needed for the buy-back, the company may borrow such cash from a financial institution if the operation of the company is stable.[24]

<Future Direction>

- **Through collaboration between securities exchanges, securities companies and local financial institutions, training seminars for employees of financial institutions, and joint seminars for financial institutions and customers, the securities industry and the local finance industry should further collaborate to foster local momentum for IPOs and provide support to individual IPO projects.**
- **Secondary funds should be used more effectively. A secondary fund should purchase shares of a business from an existing venture fund at the request of the venture fund, at a proper price determined based on the future potential, possibility of an M&A and other factors of the business, and hold the purchased shares for a given period.[25]**
- **Secondary funds should form a market for share purchases and share concentration. In addition, a program to offer an M&A matching period and a program to provide business owners with funds for buying back their shares should be created.**
- **More Business Succession Centers should be established. To promote the use of these centers, local financial institutions should collaborate with them.**
- **Parties concerned should verify the usefulness and current problems of the Green Sheet System and make improvements in the system beneficial for both companies and investors.**
- **The use of the TOKYO PRO Market should be promoted.**
- **More loans should be provided by financial institutions to business owners for buy-backs of their company's shares[26].**
- **To facilitate future share buy-backs by business owners, classes of shares with**

[24] When a financial institution which invested to a company provide a loan to that company for share buy-back, it should be noted that solid accountability is required regarding the appropriateness of the share buy-back price.

[25] Secondary funds may also play a role in disclosing proper information on the shares it possesses and attracting new investors.

[26] Small and Medium Business Investment & Consultation Corporations hold shares of small companies for a long period and provide supports for stabilizing their controlling interest (adjusting the composition of shareholders), for strengthening their business abilities (through consulting and other services) and for business succession (succession planning). In addition to provision of a loan for share buy-backs, there was opinion that financial institutions should expand their function so that they can play a role similar to Small and Medium Business Investment & Consultation Corporations.

buy-back rights should be used as the initial form of investment.

7. Collaboration between local public organizations and financial institutions

<Awareness>

As new businesses are started by utilizing local resources and based on unique local characteristics, new employment will be created and local economies will be vitalized. However, as the population is decreasing, the environment is severe for starting up new businesses while creating demand. Accordingly, in the supplementary budgets for 2012, the Ministry of Internal Affairs and Communications created a budget for supporting business start-ups that contribute to vitalization of local economies (businesses circulating and creating local economies).[27]

Local financial institutions and local public organizations have actively collaborated in participating in, or providing support to business start-ups that contribute to local vitalization. However, their current collaborations are mainly in the area of provision of public money. There was the opinion that as a close relationship has not been established, financial institutions often find it difficult to consult local public organizations about programs to promote the vitalization of local economies.

Sharing the awareness that weakening local economy would jeopardize the existence of both the local public organizations and local financial institutions, the local parties concerned should strengthen the collaboration among them, by establishing systems to actively make proposals, encourage activities and provide support to businesses that will contribute to the vitalization of local communities.

<Future Direction>

- **Within the Regional Roundtable framework, industry, academia, the finance industry and the government should collaborate. The parties concerned within the local community should work together, have positive discussions and promote activities for vitalization of local communities.**

[27] Subsidies are provided to local public organizations that promote start-ups of advanced and sustainable businesses using local resources, or that facilitate coordination among, and provide support to parties involved in the start-up of businesses that will contribute to stimulation of local economies. The subsidies are provided so that those organizations can provide financial aid to private business operators who try to start new businesses. The amount of this supplemental budget is ¥2.19 billion.

- **Collaboration between local communities should also be promoted, such as the sharing of information on successful cases of local vitalization businesses among the various regional roundtables.**
- **The Ministry of Internal Affairs and Communications and the Financial Services Agency should work together to facilitate collaboration between local public organizations and local financial institutions.**
- **When REVIC and local financial institutions provide support to local vitalization businesses via "local vitalization funds," local public organizations should provide close cooperation in supporting the start-up and operation of such businesses and encouraging participation.**

Summary

The Task Force held twelve meetings to discuss the subject "Encouraging the Supply of Risk Capital by Financial Institutions to Support Business Start-Ups and New Businesses." At each meeting, active discussions were held and positive and constructive opinions were presented by attendees from various fields, including financial institutions, institutional investors and other businesspersons. Through the discussions, and the communication made at these meetings to identify problems and find solutions, representatives from the finance industry and the government could share the same understandings as described above. They were very meaningful discussions in the light of the purpose of the Public-Private Financial Roundtable. It is also important to make efforts to carry forward the results of these discussions (future directions) into the future.

In summary, (1) financial institutions should individually make further efforts and improvements, (2) Private financial institutions should promote and enhance collaboration with other organizations in order to strengthen their support capability and programs to achieve this should be provided, and (3) the government should also take supportive action.

For (1), the discernment capability of financial institutions should be improved. Based on the results of the discussions of this Task Force, financial institutions should take positive steps to improve their discernment capability when providing support to business start-ups and new business operations. In this connection, financial institutions, under the leadership of their executives, should make ongoing efforts to establish an appropriate pricing system that considers the risk factors of individual enterprises and the difficulties involved in providing support, and to establish a performance evaluation system that helps to improve their discernment capability. It is important for them to establish a support program for business start-ups and new business operations as a sustainable business model. The government should also consider incentives for financial institutions, including establishing a system to positively evaluate excellent programs of financial institutions.

As for (2), it was opined that collaboration should take place among private financial institutions, government-affiliated financial organizations, the Organization for Small & Medium Enterprises and Regional Innovation, venture funds, the Japan Science and Technology Agency, securities exchanges, and other organizations. For private financial institutions, providing support for business start-ups and new business operations, among the growth stages of enterprises, involves higher risks than usual transactions because the growth potential of these enterprises is uncertain. Various types of knowledge and know-how should also be utilized, including techniques to supply equity funds. It is important to consider how effectively collaboration can be achieved with parties who possess such knowledge and know-how.

To strengthen such collaboration with outside expert organizations, individual financial institutions should make serious efforts. Moreover, collaboration should also be promoted through trade organizations, through establishment and utilization of local networks, and through discussions and collaborative activities among related parties from a wide range of viewpoints.

As for (3), it is important to have detailed discussions in the future among the parties concerned, including the finance industry, regarding how risks related to business start-ups and business succession should be shared and what action should be taken to strengthen collaboration among the parties. It is also important that local financial institutions actively collaborate with local public organizations and REVIC in providing support to new businesses, in order to promote the vitalization of local communities. Government agencies should also provide proper support with appropriate timing.

As explained at the beginning of this report, the results of these discussions (Future Directions) should be read as a “preliminary” report that presents general opinions expressed in the free discussions. We should continue and have further practical discussions to realize these measures. It is expected that these ongoing activities, improvement in the ability of financial institutions to support business start-ups and new business operations, and reinforcement of the ability of local communities to support business start-ups and new business operations should create an environment where entrepreneurs and business operators are encouraged to start new businesses.