Making business sense

COMPARING FUNDRAISING PRACTICES BY START-UPS IN JAPAN AND ISRAEL

Early stage funding practices in Israel and Japan shed light on the differences in their business cultures. But is this split in the approach to investment in young companies showing signs of change?

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IN OUR EXPERIENCE, REPRESENTING NUMEROUS START-UP COMPANIES IN ISRAEL OVER THE YEARS, WE HAVE SEEN THAT MOST START-UP COMPANIES ARE FORCED TO SPEND FAR MORE TIME THINKING ABOUT HOW TO GET FUNDING THAN CONSIDERING AND EVALUATING THE SOURCE OF THE FUNDS AND WHAT IT WILL MEAN FOR THEM DOWN THE LINE.

While the various funding sources could have a substantial impact on the future of a company, we have found that most Israeli startups and early-stage companies are happy to just take any money using the path of least resistance to get whatever funds they can from the easiest sources.

While pretty intuitive, this principle can have widely differing results for start-up companies, depending on the market eco-system in which they exist and hunt for funds.

Beyond the obvious observation that the specifics of each investor, including the personalities of the actual individuals, are key factors in determining the success of a company's choice of investors, we have compared the practices in Israel and in Japan. We believe the comparison between the two is illuminating.

Whereas Israeli startups, more often than not, will turn to angels as a source of early stage funding and to venture capital funds as potential sources of funding at a later stage, the same does not hold true with their Japanese counterparts, at least up until a few years ago. Japanese startups raised only $2.4billion in 2016 and about $2.5-2.66billion in venture capital investments in 2017. By comparison, Israeli startups, despite the significantly smaller local economy, raised around $5.24billion in 2017.

The difference could easily be explained by assuming that Israel simply has substantially more startups in comparison to Japan. While this is probably true, the way in which Japanese startups raise money in their early stages is most likely a factor as well.

Japanese start-up companies are far more likely to attempt to raise money via an IPO than they are to turn to VCs, even at a much earlier stage than most companies would expect to have an IPO. Some have taken to explaining this phenomenon as cultural, namely a reluctance to sign over part of their company and its management to a VC.

However, a more practical view would be that the answer is tied to the simple fact that the Tokyo Stock Exchange has relatively low thresholds for initial listings on its 'Mothers' market, which is geared to new and emerging companies.

For a new listing on the Mothers market, the capital threshold can be as low as Japanese Yen ¥0.5billion (about $4.5million). This relatively low threshold opens the door for an early stage company to raise money via an IPO, which would be unattainable for companies at a similar stage in parallel markets.

Another potential reason for the relatively low level of VC activity in Japan is the prevalence of corporate VCs (CVCs) in contrast to the more traditional VCs.

CVCs are funds established by large corporations as a vehicle to invest in startups and other early stage companies. CVC investment constitutes approximately two-thirds to four-fifths of all VC-backed deals in Japan versus only about one-fifth in the US and slightly more than one-third in Israel.

Another interesting finding is that around ten per cent of the top 300 CVC funds in the world are from Japan.

Some examples of Japanese CVCs are Mirai Creation Investment, a fund created by Toyota together with SMBC and Sparx (an asset management company), The Sony Innovation Fund set up by Sony, Alliance Ventures set up by Renault–Nissan–Mitsubishi, 31 Ventures established by Mitsui Fudosan and managed by Global Brain, a Japanese VC fund, Sosei CVC established by Sosei, a biopharma company, and the Nikon-SBI Innovation Fund established by Nikon Corporation and SBI.

Nonetheless, Japan has seen a rise in VC funding over the past few years, which could be an indicator that the trend may become more and more popular amongst Japanese startups. This may be enticing for foreign VCs who had not previously paid attention to the Japanese market.

On one of our recent trips to Japan, several of the industry leaders we met expressed some frustration regarding the difficulties surrounding funding for Japanese start-ups. They are disappointed with the 'premature IPO' phenomenon, which more often than not results in a fall-out in the share price within a couple of years of the IPO.

The problems of going public too early are not unique to Japan and we have seen this with clients in different jurisdictions over the years. The industry seems to cause these types of waves from time to time and companies are tempted by what seems like the most painless route to funding.

However, there can be many disadvantages to being a public company.

For example, in a company with low revenues, the disclosure requirements on financials and contractual activity can get in the way of being a nimble early stage company. In addition, there are ongoing compliance headaches and costs, both of which can be a significant financial burden on a young company and require internal and external staff. Another factor is the potential media spotlight on the company, which can quickly turn issues that would have had little impact in a private company into major issues for a public company and its share price.

Moving forward, we hope to see the angel and VC community growing in Japan and increasing their market share in comparison to corporate VCs, which we believe would have a beneficial impact on Japan's start-up community. ●

Peter Sugarman and **Eliran Furman** are corporate partners at Israeli law firm Yigal Arnon & Co. The firm provides a full range of legal services to meet the differing needs of clients across a variety of industries. Founded in 1957, it is one of the largest law firms in Israel with offices in Tel Aviv and Jerusalem.