1. SME Trends

The overall economy has been slumping since the second half of FY2000, and conditions have gotten dramatically worse for SMEs. This has been especially pronounced in I.T. and other electrical equipment.

![Graph of SME economic outlook and manufacturing indices for SMEs](image1)

Source: SME Agency/JASMEC, Business Condition Survey in the SME Sector

NB: The differential index is derived by subtracting "has deteriorated" responses from "has improved" responses.

2. SME financing situation

Financing situation is very bad for the SMEs—almost as bad as they were during the financial crisis of 1998.

![Graph of SME financing situation](image2)

Source: SME Agency/JASMEC, Business Condition Survey in the SME Sector
3. SME Bankruptcies

The number of SME bankruptcies in 2001 was the 3rd highest ever (and the total number of bankruptcies the 2nd highest ever). There was a particularly sharp increase in bankruptcies of long-established SMEs.

![Graph showing high bankruptcy levels among SMEs](source: Tokyo Shoko Research)

4. Deflation’s Impact on SMEs

Even as average SME sales prices have slipped, there has also been slippage in sales volume. As a result, SME profits are off.

![Graph showing sales prices and volume](source: SME Agency, Wholesale Price Indices by Size of Firm, Ministry of Finance, Financial Statements Statistics of Corporations by Industry)
5. Impact of Offshoring (Hollowing) on SMEs in Manufacturing

More companies are moving more of their production offshore and getting more offshore sales, which is having a major impact on domestic Japanese manufacturing SMEs. There has been a precipitous drop in the number of Japanese manufacturing plants, and this has been particularly conspicuous in manufacturing regions. Business networks have been weakened, and subcontractors have been especially hard-hit.

Source: METI, Basic Survey of Overseas Business Activities
NB 1. Offshore production ratio derived by dividing offshore subsidiary sales by in-Japan company sales (both manufacturing).
2. Figure for FY2000 is estimate.

Source: METI, Survey of Business Trends

Source: METI, Census of Manufactures
NB: Numbers of establishments and employees both totals for establishments with 4 or more employees.
A recent survey of subcontracting SMEs revealed that they respond with restructuring or business innovation when parent companies move operations offshore. Business innovation is more effective for the company than restructuring. (10,000 SMEs surveyed. Valid responses from 1,964.)

Restructuring and business innovation to counter hollowing

- Business strategies adopted by subcontractors whose parents go offshore -

- Find new customers
- Expand offshore production
- Cut production costs
- Develop higher-value products
- Emphasize R&D
- Use I.T. more
- Trim personnel
- Downsize facilities

Source: SME Agency, Survey of Hollowing-out’s Impact on Subcontractors (1,964 responses)

NB: 1. Totals exceed 100 because of multiple responses.
2. Figures are responses taken in 1986-90 when parent companies moved operations offshore.

Companies that responded to parent company’s move offshore with business innovation have stronger sales

- Sales compared to SME business strategies -

- Use I.T.
- Emphasize R&D
- Develop higher-value products
- Cut production costs
- Trim personnel
- Downsize facilities

Source: SME Agency, Survey of Hollowing-out’s Impact on Subcontractors (1,964 responses)

NB: Figures are correlation between business strategies taken in 1986-90 when parent companies moved operations offshore and SMEs’ 2001 sales increase or decline.
Part 2. SME Creation and Growth

1. SME Start-ups

Even though the number of would-be entrepreneurs has been over 1 million for each of the last 20 years (1.24 million recently), there has been a long-term decline in the start-up ratio.

![Graph showing start-up ratio](image)

Source, Ministry of PMHAPT, Employment Status Survey

NB: Figures show more entrepreneurs than the Ministry’s survey does because they also include SOHOs and other establishments not included in that survey.

The would-be group of over 1 million is more skewed to young, highly educated males than the actual entrepreneur group is.
As asked, what difficulties they encountered in starting ups, more people cited financial problems than anything else. Other major areas included marketing and human resources. Systemic problems were also another major area.

**Impediments to start-ups**

- Funding perceived as barrier by many

<table>
<thead>
<tr>
<th></th>
<th>Financing</th>
<th>Marketing</th>
<th>Personnel</th>
<th>Systemic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short of own capital</td>
<td><img src="chart1" alt="" /></td>
<td><img src="chart2" alt="" /></td>
<td><img src="chart3" alt="" /></td>
<td><img src="chart4" alt="" /></td>
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<tr>
<td>Financing for start-ups</td>
<td><img src="chart5" alt="" /></td>
<td><img src="chart6" alt="" /></td>
<td><img src="chart7" alt="" /></td>
<td><img src="chart8" alt="" /></td>
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<tr>
<td>Finding customers</td>
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<td><img src="chart10" alt="" /></td>
<td><img src="chart11" alt="" /></td>
<td><img src="chart12" alt="" /></td>
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<tr>
<td>Finding vendors</td>
<td><img src="chart13" alt="" /></td>
<td><img src="chart14" alt="" /></td>
<td><img src="chart15" alt="" /></td>
<td><img src="chart16" alt="" /></td>
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<tr>
<td>Market research &amp; analysis</td>
<td><img src="chart17" alt="" /></td>
<td><img src="chart18" alt="" /></td>
<td><img src="chart19" alt="" /></td>
<td><img src="chart20" alt="" /></td>
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<tr>
<td>Finding human resources</td>
<td><img src="chart21" alt="" /></td>
<td><img src="chart22" alt="" /></td>
<td><img src="chart23" alt="" /></td>
<td><img src="chart24" alt="" /></td>
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<tr>
<td>Lack of managerial know-how</td>
<td><img src="chart25" alt="" /></td>
<td><img src="chart26" alt="" /></td>
<td><img src="chart27" alt="" /></td>
<td><img src="chart28" alt="" /></td>
</tr>
<tr>
<td>Lack of financial and legal expertise</td>
<td><img src="chart29" alt="" /></td>
<td><img src="chart30" alt="" /></td>
<td><img src="chart31" alt="" /></td>
<td><img src="chart32" alt="" /></td>
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<tr>
<td>Administrative Paperwork</td>
<td><img src="chart33" alt="" /></td>
<td><img src="chart34" alt="" /></td>
<td><img src="chart35" alt="" /></td>
<td><img src="chart36" alt="" /></td>
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<tr>
<td>Regulations on the business sector</td>
<td><img src="chart37" alt="" /></td>
<td><img src="chart38" alt="" /></td>
<td><img src="chart39" alt="" /></td>
<td><img src="chart40" alt="" /></td>
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<tr>
<td>Selecting location</td>
<td><img src="chart41" alt="" /></td>
<td><img src="chart42" alt="" /></td>
<td><img src="chart43" alt="" /></td>
<td><img src="chart44" alt="" /></td>
</tr>
<tr>
<td>Shift from idea to business</td>
<td><img src="chart45" alt="" /></td>
<td><img src="chart46" alt="" /></td>
<td><img src="chart47" alt="" /></td>
<td><img src="chart48" alt="" /></td>
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<tr>
<td>Selection of business area</td>
<td><img src="chart49" alt="" /></td>
<td><img src="chart50" alt="" /></td>
<td><img src="chart51" alt="" /></td>
<td><img src="chart52" alt="" /></td>
</tr>
<tr>
<td>Obtaining expert advice</td>
<td><img src="chart53" alt="" /></td>
<td><img src="chart54" alt="" /></td>
<td><img src="chart55" alt="" /></td>
<td><img src="chart56" alt="" /></td>
</tr>
<tr>
<td>Others</td>
<td><img src="chart57" alt="" /></td>
<td><img src="chart58" alt="" /></td>
<td><img src="chart59" alt="" /></td>
<td><img src="chart60" alt="" /></td>
</tr>
</tbody>
</table>


NB: Totals exceed 100 because of multiple responses.

Financing was especially daunting for young entrepreneurs. Family, friends, and other personal-network associates were important sources of funding.
While about 30% of new enterprises fold within one year, a higher number of them became profitable within two years. Young people with the working experience in the same field were especially likely to succeed. Yet even though young people are likely to succeed, many of their plans never get off the ground because of funding difficulties. This is a major problem.

![Graph showing closure ratio by number of years from establishment's founding.](source)

![Graph showing ratio of companies in black within 2nd year.](source)

Source: Adapted from METI, Census of Manufactures


NB: Only statistically significant samples were included in the stratification.
There has been a long-term decline in the Japanese start-up ratio. While the overall economic down-turn is one factor here, another major factor is that self-employed people's incomes have not kept up with other-employed people's incomes.

Start-up and closure ratios (except primary sector, annual averages)

- Fewer start-ups than during the rapid-growth years -

Source: Adapted from Ministry of PAHAPT, Establishment and Enterprise Census

Ratio of self-employed income to other-employed income

- Decline in ratio of self-employed to other-employed income since early 1970s -


Start-up ratio and ratio of self-employed income to other-employed income

- Start-up ratio correlates with income ratio -

Companies, like people, have less growth potential as they grow older. Yet business innovation can be a “fountain of youth” and restore a company’s growth potential.
Prominent SME business innovations are efforts to develop new products and to develop new means of managing customer relations and internal resources.

Priority activities
- Major push to broaden appeal -

New products and new technologies
- Develop new products
- Develop new technologies
- Improve current products
- Diversify

Business shift
- Go into different business
- Initiate new means of managing customer relations and in-house personnel
- Change internal management
- Improve manufacturing process

New methods & institutional arrangements
- Initiate or change joint marketing program
- Initiate or change joint production program

Joint operations
- Go overseas
- New advertising strategies

Others

SME Agency, Survey on Enterprise Business Innovation (2001)

R&D is closely related to business innovation. SMEs are more willing to undertake high-risk R&D than large companies are.

Willingness to do R&D with less than 50% likelihood of success (manufacturing)
- SMEs also aggressive in high-risk R&D -

SME Agency, Survey on Corporate Business Innovation (2001)
Although SMEs have not done as much as large enterprises have to link to universities, those that have gotten the same benefits as large companies have. Lack of information is one major reason SMEs have held back here.


Impact of tie-ups with universities


NB: Increase/decrease is simple average for 1997-2000.
A recent survey of 5,000 shopping-street associations (valid responses from 1,702) showed that some of the associations had succeeded to increase traffic by the coherence of community to innovate their businesses, ex. Attract shops, maintain a good mix of them, even if department or super-market stores closed.

Source: SME Agency, Survey of Conditions in Shopping Areas (November 2001)
3 . Bankruptcies and the Lessons Therefrom

The December 2001 survey of 200 people whose firms failed showed that Japanese entrepreneurs are less likely than U.S. entrepreneurs to start new companies after going bankrupt once. Likewise, the 40% of bankrupt entrepreneurs who want to start new companies again is lower than the U.S. figure.

Desire or not to start another company
- Although fewer than in the U.S., many Japanese entrepreneurs with bankruptcy experience want to start another company -

Source: Compiled by the SME Agency. U.S. data are 1994 data from the Small Business Administration. NB: It should be noted that the term “working” may be perceived differently in the two countries.
Lack of financing and business trust are major impediments to post-bankruptcy start-ups.

Impediments to starting another company
- Financing is the major barrier faced by people wanting to start another company -

<table>
<thead>
<tr>
<th>Impediment</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal problems</td>
<td>2.9%</td>
</tr>
<tr>
<td>Business trust problems</td>
<td>11%</td>
</tr>
<tr>
<td>No desire to start another company</td>
<td>29.5%</td>
</tr>
<tr>
<td>Still cleaning up after the bankruptcy</td>
<td>27.7%</td>
</tr>
<tr>
<td>Financing problems</td>
<td>22.0%</td>
</tr>
<tr>
<td>Others</td>
<td>6.9%</td>
</tr>
</tbody>
</table>

Source: Based upon SME Agency interviews

There are successful asset-poor start-ups. Most of these back-from-the-dead entrepreneurs succeed because they learn from failure and manage better the second time around.

Asset positions immediately after closure
- Even those whose savings were wiped out and who had to sell their home or store do well the second time around -

<table>
<thead>
<tr>
<th>Asset Position</th>
<th>First-time start-up</th>
<th>Second-time start-up</th>
</tr>
</thead>
<tbody>
<tr>
<td>Home</td>
<td>Virtually gone</td>
<td>Some left</td>
</tr>
<tr>
<td>Cash &amp; savings</td>
<td>Old to pay to pay off debts</td>
<td>Did not own in first place</td>
</tr>
</tbody>
</table>


How the second start-up does
- Second start-ups have stronger bottom lines -

Present P/L position (for companies within 29 months of founding)

<table>
<thead>
<tr>
<th>Present P/L position</th>
<th>First-time start-up</th>
<th>Second-time start-up</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basically in black</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Basically in red</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: National Life Finance Corporation Research Institute, Research on the Second Challenge of Business Start-ups (November 2001)
4. Issues in SME Financing

There has been a sharp drop-off in financial institutions’ lending to SMEs.

A survey of FY1998-00 balance sheets from 460 financial institutions nationwide shows that those with high NPL ratios did not increase their SME lending much but were upbeat on lending to big companies. The NPLs’ impact on SME lending was especially pronounced at city banks.

NB: NPL ratio derived by dividing NPLs by total assets.
Interest rates vary widely among SMEs. Equity capital ratios are thought to be a major factor here.

### Short-term interests rates by company size (2001)
- Interest rates are higher the smaller the company -

<table>
<thead>
<tr>
<th>Interest rate on borrowings</th>
<th>3.500%</th>
<th>1.875%</th>
<th>1.500%</th>
<th>1.375%</th>
<th>2.375%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Median</td>
<td>1.250%</td>
<td>1.250%</td>
<td>1.250%</td>
<td>1.250%</td>
<td>1.250%</td>
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<tr>
<td>Median</td>
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<td>1.250%</td>
<td>1.250%</td>
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<tr>
<td>Bottom 25%</td>
<td>1.000%</td>
<td>1.000%</td>
<td>1.000%</td>
<td>1.000%</td>
<td>1.000%</td>
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<tr>
<td>Top 25%</td>
<td>2.000%</td>
<td>2.000%</td>
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<td>2.000%</td>
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<tr>
<td>Bottom 25%</td>
<td>1.500%</td>
<td>1.500%</td>
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<td>1.500%</td>
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<tr>
<td>Top 25%</td>
<td>2.500%</td>
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<tr>
<td>Median</td>
<td>1.250%</td>
<td>1.250%</td>
<td>1.250%</td>
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<tr>
<td>Bottom 25%</td>
<td>1.000%</td>
<td>1.000%</td>
<td>1.000%</td>
<td>1.000%</td>
<td>1.000%</td>
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<tr>
<td>Top 25%</td>
<td>2.000%</td>
<td>2.000%</td>
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<tr>
<td>Bottom 25%</td>
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<tr>
<td>Top 25%</td>
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<tr>
<td>Median</td>
<td>1.250%</td>
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<td>Bottom 25%</td>
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<td>Top 25%</td>
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</table>


NB: Top 25%, median, and bottom 25% are in terms of interest rate paid.

### Interest rates on short-term loans by equity capital ratios (2001)
- The lower the equity capital ratio, the higher the interest rate -

<table>
<thead>
<tr>
<th>Equity capital ratio</th>
<th>Under 0%</th>
<th>1.665%</th>
<th>1.661%</th>
<th>1.753%</th>
<th>1.892%</th>
<th>2.185%</th>
<th>2.328%</th>
<th>2.492%</th>
<th>2.896%</th>
</tr>
</thead>
<tbody>
<tr>
<td>5% or less</td>
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<td>10% or less</td>
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<td>20% or less</td>
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<td>30% or less</td>
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<td>40% or less</td>
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<td>50% or less</td>
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</tbody>
</table>

SMEs are more dependent than large firms on regional banks and Shinkin banks. Likewise, large banks are more likely to refuse or shave lending to SMEs than regional banks and Shinkin banks.

Source: SME Agency, Survey of the Corporate Capital Procurement Climate (December 2001)

NB: 1. Shows percentage of firms that were refused credit or had to scale back their request when they went to their main financial institution for a loan in 2001.
2. Large banks are city banks, long-term credit banks and trust banks.
3. It should be noted that very few companies with over 100 employees have shinkin or credit associations as their main financial institutions (only 35 with 101-300 employees and only 1 with over 300 employees).
20-30% of SMEs are interested in direct financing, but very few actually can. Among the barriers to SMEs raising money from capital market are that they are not set up to meet disclosure requirements or do not meet listing requirements. Therefore, it is important for SMEs to make the most use of the diversity of their sources of capital, such as loans with account receivables, private placements bonds that financial institutions buy or private bonds that family, friends, and other personal-network members buy.

**Reasons of not raising direct financing**

- Disclosure and systemic requirements are major barriers -

Source: SME Agency, *Survey of the Corporate Capital Procurement Climate (December 2001)*

NB: Totals exceed 100 because of multiple responses.
5. Employment Creation and Shrinkage at SMEs

Over the last decade, SEs have accounted for considerable job creation and have been important sources of employment. Start-ups also have a major impact on employment.

Changes of the employment in establishments existing between 1991-99 (except primary sector)

Employment has declined the bigger the establishment. Employment is up at establishments with 1-5 people.

Source: Adapted from Ministry of PAHAPT, Establishment and Enterprise Census

Employment 1991-99 (except primary sector)

- Closings have major impact on employment -

Source: Adapted from Ministry of PAHAPT, Establishment and Enterprise Census
There has been a major burst of community entrepreneurs, and hence self-employed people, in the U.S., UK, and elsewhere since 1980. Its cumulative effect has been to revitalize their economies. Japan needs to work on encouraging a similar situation and effect.

New business formation as seen in the number of self-employeds
(1980 = 100)

Changes in ratio of self-employed to total private-sector employment (except primary sector) from 1980 to 2000

Source: OCED, 2000 Labor Force Statistics

NB: Self-employeds are defined as employers and persons working on their own account.