

CFOs Hold Key for SMEs

What are the special characteristics of successful, fast-growing small and medium-sized enterprises (SMEs)? Kobe University Professor **Kenji Kutsuna** outlines the findings of his recent research into the situation in Japan from the perspective of capital financing.

Who do we count on to create new jobs? A review of government efforts over the past few years to support new business startups does show that the number of new business startups now exceeds that of business failures, which seems to show that policy-makers may be focused mainly on promoting new businesses. And yet, not all business startups create jobs at the same pace. Rather, a very small number of fast-growing companies are clearly creating the great majority of new jobs. Professor David Storey, for example, a leading British researcher in the field of small and medium-sized enterprises (SMEs), looked at the contribution which SMEs made in creating jobs over the first ten years after their establishment. He found that just 4% of the fastest growing SMEs created some 50% of the jobs on a net basis. This same trend has been confirmed in studies of Germany.

Given these findings, much attention in recent years has focused on research studies analyzing the distinct features of fast-growing SMEs. The leading accounting firm Deloitte Touche Tohmatsu, for instance, has been conducting a project since 1996 to analyze the hallmark fast-growing SMEs described as “The Ten Percenters,” or the top ten fastest growing

SMEs in the United Kingdom. Given fears of rising unemployment in Japan, there’s hardly any need to point out that more fast-growing SMEs are needed. Unemployment is particularly high in Kansai and in regional areas. Creating jobs is therefore an important item on the policy agenda for local governments. In October of 2003, a poll was conducted focusing on SMEs located in Osaka which had been in business for ten years. Based on these data, let’s examine the contribution of fast-growing SMEs in creating jobs.

Table 1 ranks SMEs according to their contribution in creating jobs. The 536 responding companies created a total of 2,831 new jobs all told. However, the ten companies creating the most jobs (sixty-one or more) accounted for 1,054 of all the new jobs, or 37.2% of the total. In short, the fast-growing SMEs accounting for less than 2% of the new startups studied created nearly 40% of the new jobs. The thirty companies contributing the most new jobs (twenty-five or more) accounted for a total of 1,811 new jobs, or 64.0% of the total. In short, 5.6% of the companies created 64% of the jobs, which is basically in line with Storey’s finding of 4% of the fastest growing SMEs creating 50% of the new jobs. It can thus be seen that new Japanese startup companies do

not create an equal, average number of jobs. Rather, a very small number of fast-growing SMEs account for the lion’s share of new jobs.

In this way, the Japanese SMEs which boast fast growth rates amount to just 4% to 5% of the total. Yet foreign and domestic studies both clearly show that these fast-growing SMEs contribute more than 50% of the new jobs created on a net basis. These enterprises also play a critical role in innovation, and many observers have highlighted the need to create more such companies.

Even without reference to the U.S. comparison, however, it is difficult to argue that the kind of fast-growing companies able to fuel Japan’s economy are emerging over a short time from among new business startups. A look at present SME policy shows there is still resistance to any concentrated support for a small number of fast-growing SMEs.

I have highlighted the need to pursue studies aimed at clarifying the special characteristics of fast-growing SMEs. Amid rising interest in fast-growing SMEs around the world, the Organization for Economic Cooperation and Development (OECD) in 2007 initiated a massive project aimed at identifying the special characteristics of fast-growing SMEs through case studies focusing on five themes, namely innovation, business practices, networking, intellectual asset management and financing. I was in charge of studying the situation in Japan from the perspective of capital financing and completed a report in August of this year following a case study of seven companies.

Based on the analytical framework used by Professor Storey as shown in **Table 2**, a past study I made of companies located in the city of Osaka found that the acceptance of equity participation from outsiders and the preparation of a business plan were two factors directly influencing the ability of a firm to raise capital. In interviews with the seven companies

Table 1. Job creation by SMEs

	<i>Percentile rank</i>	<i>Net staff increase (officers + employees)</i>	<i>Contribution to total increase</i>
Top 10 (increase ≥ 61)	1.9%	1,054	37.2%
Top 30 (increase ≥ 25)	5.6%	1,811	64.0%
Top 48 (increase ≥ 17)	9.0%	2,159	76.3%
Top 93 (increase ≥ 9)	17.4%	2,657	93.9%
Total (536 companies)	100.0%	2,831	100.0%

Table 2. Factors influencing growth in small firms

<i>The entrepreneur/resources</i>	<i>The firm</i>	<i>Strategy</i>
1. Motivation	1. Age	1. Workforce training
2. Unemployment	2. Sector	2. Management training
3. Education	3. Legal form	3. External equity
4. Management experience	4. Location	4. Technological sophistication
5. Number of founders	5. Size	5. Market positioning
6. Prior self-employment	6. Ownership	6. Market adjustments
7. Family history		7. Planning
8. Social marginality		8. New products
9. Functional skills		9. Management recruitment
10. Training		10. State support
11. Age		11. Customer concentration
12. Prior business failure		12. Competition
13. Prior sector experience		13. Information and advice
14. Prior firm size experience		14. Exporting
15. Gender		

Source: Storey (1994), p. 123.

in my recent study, I found that these characteristics were once again prominent features among the fastest-growing SMEs. As shown in the **figure**, however, the recruiting of managerial talent, and the addition of a chief financial officer (CFO) in particular, was an important factor in the achievement of fast growth.

Needless to say, it is critical that managers at SMEs work to deepen their expertise if their firm is to achieve high growth. For companies requiring high levels of managerial specialization, however, recruiting of managerial staff who can supplement the company's expertise with their own specialized knowledge is critical to the achievement of fast growth. Managers of venture companies in the technology field, for example, often lack knowledge related to capital financing. In that regard, a critical role is played by a CFO who can analyze the risks of the business, draw up a financing strategy to obtain growth capital and finalize a business plan.

In the OECD project, I first identified fast-growing SMEs using the database of Tokyo Shoko Research and then conducted a survey on these companies to select seven fast-growing SMEs making significant efforts in the area of obtaining financing. With the exception of one company founded in August of 1994, these were companies which had been in business less than ten years. The number of current staff

(including officers and employees) was fairly broad at from 51 to 122, but one could say they had added positions at a fairly brisk pace over the decade or so since their establishment. With the exception of one company, all had sales exceeding 1 billion yen in 2007, with the year-on-year growth rate of five companies at 100% or more. Of significant interest was the fact that, at two of the seven, recruiting of a CFO provided an opportunity to overhaul the firm's business plan and made it possible to formulate sophisticated financial judgments and smooth the process of obtaining financing in the form of bank loans and venture capital. Doubtless many points will be of reference in considering the

state of future growth for SMEs. Below, let's examine the impact brought about from the addition of a CFO at the two companies in detail.

Case Studies

Bictown operates an e-commerce planning business based in Tokyo's Chuo ward. Two years ago, a certified tax accountant serving as the company's advisor was hired as financial officer. I shall call him "Mr. A." At the time of its founding, the company applied for a loan of 20 million yen (210,000 dollars) from a government-affiliated financial institution but was only able to obtain five million. After Mr. A joined the company, however, obtaining bank loans became easier. With a view to conducting an IPO, the company overhauled its business plan, which was well received by venture capitalists, and many came forward with offers of financing.

However, the company enjoyed a good cash flow with the steady growth of its business. The CFO decided the best strategy would be to obtain financing from venture capitalists under the best terms possible by waiting until the company got its business on an even better track and was able to increase its market capitalization. The company then increased its capital through an allocation of shares to venture capitalists and other investors and obtained 150 million yen (1.6 million dollars) in March of 2007. It did so only after boosting its market capital-

Either recruiting a CFO from outside or training one within the company contributes significantly in helping an SME achieve rapid growth. In particular, the presence of a CFO is indispensable in building equal business relationships between the SME and financial institutions, coping with instabilities and risks in the company's financial position, and obtaining risk capital from outside.

ization to about 1 billion yen, making it possible to limit the equity participation of the venture capitalists to about 13%. One could therefore say that, in addition to making loan negotiations with banks go more smoothly, the addition of the financial officer made it possible to limit any dilution in the equity share of existing stockholders.

Another company is Advanced Communications, a research and development manufacturer based in the city of Numazu, Shizuoka Prefecture. The president had a background in technology. Two years ago, “Mr. B” joined the firm. After graduation from college, B worked five years as a banker in loan operations. He then

ny sought a means of raising the capital. He arranged a meeting of venture capitalists through the network he had put together while working in his volunteer organization. B then drafted materials for submission to venture capitalists based on interviews with the company management.

When the company’s cash flow came under pressure, B participated in negotiations with financial institutions and engaged in rounds of talks with the firm’s main bank and other institutions in order to finalize the transactions. As a result, it was possible not only to lower the guarantee fee charged by the credit guarantee association but also to lower the interest

also based on his belief in the need to boost enterprise value by searching for just what a “truly great company” is from the viewpoint of highly discriminating investors.

Accepting Risk

As seen above, the CFO constitutes an important element in the growth of SMEs in terms of boosting the strength of management in the area of finance. That said, people having the qualifications to serve as CFO for an SME are in very short supply. At large enterprises, the CFO is supported by general managers of finance and accounting, each of whom plays a specialized role. The typical SME, however, will have only a few employees handling such tasks as accounting or general affairs, while the president himself will be in charge of raising capital with no financial manager on hand at all.

Yet, as is clear from this study, either recruiting a CFO from outside or training one within the company contributes significantly in helping an SME achieve rapid growth. In particular, the presence of a CFO is indispensable in building equal business relationships between the SME and financial institutions, coping with instabilities and risks in the company’s financial position, and obtaining risk capital from outside.


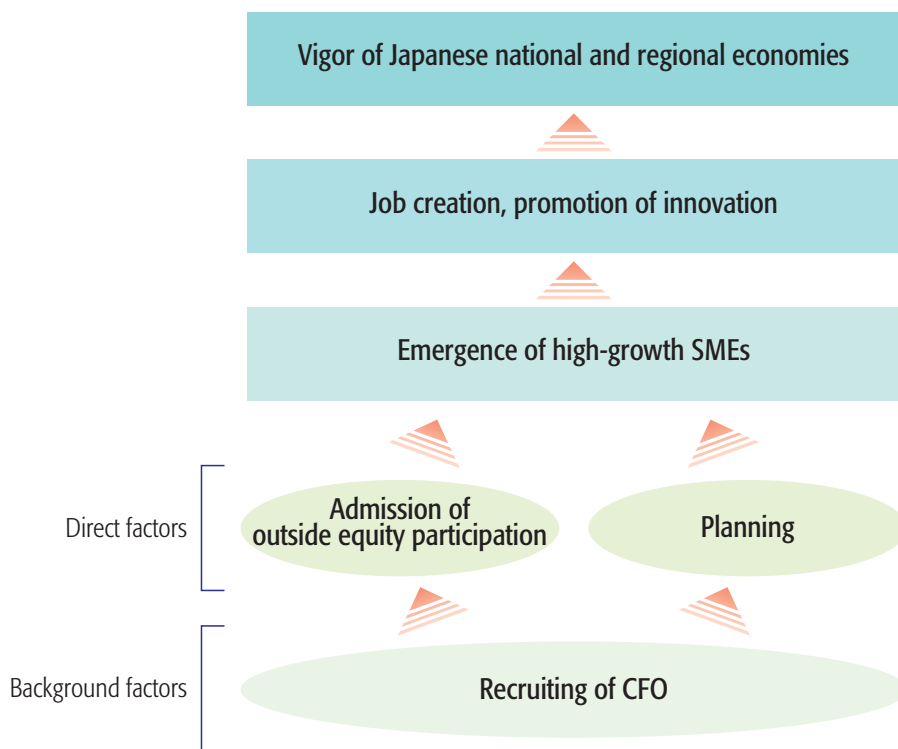
According to the 2008 *Annual Report on Japanese Economy and Public Finance*, the unwillingness on the part of Japanese companies and households to accept risk is one factor in the nation’s slow pace of economic growth. It emphasizes that, given the economy’s limited opportunities for macroeconomic growth, the Japanese need to be more willing to accept appropriately managed risk. In the case of SMEs, it is clearly the presence of a CFO which will make that possible. In the future, it will be critical to provide SMEs not only with an environment to facilitate the recruiting of CFOs from outside but also with the educational resources needed for the training of such personnel within the company. 

Figure : Factors influencing the growth of SMEs



served another eight years at an auditing firm, where he was active in share listings, human resources and company restructurings. On his own, meanwhile, B organized and worked in a volunteer organization to support venture companies.

At a time when Advanced Communications had a capitalization of 30 million yen (315,000), it found itself in need of about 100 million yen for product development. B was ultimately the one consulted when the compa-

ny sought a means of raising the capital. He arranged a meeting of venture capitalists through the network he had put together while working in his volunteer organization. B then drafted materials for submission to venture capitalists based on interviews with the company management.

When the company’s cash flow came under pressure, B participated in negotiations with financial institutions and engaged in rounds of talks with the firm’s main bank and other institutions in order to finalize the transactions. As a result, it was possible not only to lower the guarantee fee charged by the credit guarantee association but also to lower the interest rate on the loan from the prevailing average of 3.7% to just 1.15%.

B says he always believes that the obvious task of the person working behind the scenes is to enable the company to escape the trap of having to abandon development for lack of funds and to keep it on a solid financial footing so it can make its sophisticated technology broadly available in the world and enter a cycle of growth. His present efforts in financing negotiations with venture capitalists are

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