



JAFCO America Ventures, Inc.: Building a Venture Capital Firm

"Par!" Barry Schiffman, president and chief investment officer of JAFCO America Ventures, Inc. (JAV) was delighted about his performance in JAV's golf tournament. The tournament was part of JAV's first strategy retreat meeting held in Applewood, California two hours north of Palo Alto. If he got par on the last three holes of the Applewood golf course, he had a chance of winning the \$600 prize money at stake. It was Friday, August 22, 1997 and Schiffman and all 14 employees and partners of JAV, including spouses, were enjoying the pleasant natural surroundings of Northern California's hills.

As Schiffman took a stance for his next tee shot, Hitoshi Imuta, chairman and chief operating officer of JAV, looked on. They exchanged a friendly smile. Imuta had recruited Schiffman to JAV in October 1996 from the renowned Silicon Valley venture capital firm Weiss, Peck and Greer Venture Partners where Schiffman had been a general partner. Since October 1996, Imuta had worked closely with Schiffman in rebuilding JAV after three of JAV's previous investment principals had left between April and August 1996 in a sweeping blow to JAV's parent company Japan Associated Finance Co., Ltd. (JAFCO).

Schiffman reminded himself that the challenges that lay ahead of him at JAV were more formidable than the task of scoring par on four successive golf holes. Schiffman reflected on his opening words for the strategy retreat on the previous day:

We have come a long way since October 1996 and I would like to thank all of you for your efforts over the last months. But let's be clear about this: some of the biggest obstacles in making JAFCO America Ventures an outstanding venture capital firm are still ahead of us. This retreat will lay the foundation for our efforts over the next year. This meeting is not only about developing an investment strategy but also about improving our execution capabilities. JAFCO America Ventures has access to unique resources. We must cultivate and use these resources more productively than we did in the past.

Schiffman felt he had done a good job in acknowledging his team's past efforts as well as in creating an increased sense of urgency among team members. However, numerous questions went through his mind: How should he go about recruiting an enterprise software partner to round out

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JAFCO's investment team? What was the best way to expand JAV's investment activities into life sciences? How could JAV improve the value-added activities provided to JAV's portfolio companies by JAFCO, JAV's parent company? Schiffman was particularly worried that JAFCO's flat compensation structure in Japan would trigger some of JAFCO's employees who were most valuable to JAV to leave the company. Schiffman summarized his challenge:

I have been recruited to manage a turnaround in a venture capital firm that has been drained of its principals. But beyond managing the turnaround there is a more fundamental question: How can we create one of the most uniquely positioned venture capital firms in the industry? How can we get into the best deals, achieve impressive returns and create a brand equity that rivals the best firms in Silicon Valley and Boston?

JAFCO and JAFCO America Ventures: The Origins

Japan Associated Finance Co., Ltd. (JAFCO) was established in 1973 as a joint venture between Nomura Securities Co., Ltd., Nippon Life Insurance Co., and the Sanwa Bank, Ltd. as the pioneering venture capital firm in Japan. The principal activities of JAFCO and its Japanese consolidated subsidiaries were investing in and offering consulting and information services to private companies with high potential for future growth. From its inception through March 31, 1997, JAFCO made investments in 1,656 venture businesses, backed initial public offerings (IPOs) of 423 companies, and managed 49 partnership funds with a cumulative ¥251.2 billion (\$2.13 billion; US\$1=¥118 in 8/97) in committed capital. JAFCO and its subsidiaries employed 406 people. (See Exhibit 1 for JAFCO's organization chart.) In its fiscal year 1997, JAFCO achieved an operating profit of \$102 million on total assets of \$2,197 million. (See Exhibit 2 and 3 for balance sheets and income statements.)

Unlike most U.S. venture capital firms, JAFCO was publicly held and traded on the Japanese OTC (see Exhibit 4). JAFCO's senior managers owned only a negligible share of the firm's equity and did not participate in its profits beyond an annual bonus not exceeding the base salary. JAFCO's investments were focused mainly on manufacturing and service industries and not solely on high technology sectors. In contrast to the United States, most technology development and commercialization in Japan is conducted in-house by large Japanese electronics, engineering, and pharmaceutical firms. JAFCO, with its 371 employees (not counting employees in subsidiaries) and 6 branch offices, was very large when compared to U.S. venture capital firms with an average of 3.5 partners. JAFCO used a highly structured process of screening a large number of potential portfolio companies, evaluating a smaller number of them in detail and eventually acquiring up to 10% of a portfolio firm's equity (see Exhibit 5). Over the years, JAFCO's performance had been quite good by Japanese standards. Generally, JAFCO's portfolio companies were taken public by Nomura's investment banking division. In Japan it took more than five years from the investment of a firm to its IPO for about 60% of all firms that went public. In the United States, by contrast about 60% of the firms went public in less than five years (see Exhibit 6).

JAFCO's international expansion started in March 1983 with the establishment of JAFCO International (Asia) Ltd. in Hong Kong. In July 1984, JAV was established in Menlo Park, CA, and in February 1986, a representative office for Europe was established in London. JAFCO wanted to achieve two objectives by going abroad: first, the firm wanted to gain access to additional sources of capital for investments in Japan. Second, JAFCO's leaders wanted to learn more about the venture capital industry in the United States. In order to create deal flow, JAV had invited a number of partners at renowned VC firms, including such firms as Kleiner-Perkins, to join its advisory board. The former president, Mr. Yoshida, commented:

It was our main goal to source additional capital, but at the same time we were intrigued by the evolving venture capital industry in the United States and venture capital funded success stories like Lotus and Compaq. We thought that a couple of years down the road there might be something that JAFCO could learn from the venture capital (VC) system in the U.S.

Between 1984 and 1994, JAV focused on raising capital from U.S. investors. For that purpose, JAV opened an office in New York City in 1985, which became JAV's headquarters in 1988. JAFCO also moved its Menlo Park office to San Francisco in 1987. (See Exhibits 7 and 8 for a list of investors in JAV's funds raised in the United States and invested in Japan.)

Between 1987 and 1996, JAV was successively headed by Shunsuke Fukuda, Shouichi Fujikawa, and Masahiko Saitoh, all Japanese nationals who had been temporarily transferred from Japan. In 1986, Bob Shell was hired as a fund manager. Shell's main role was to act as an administrative head for JAV and to manage the relationship with investors to give JAV increased access to capital. In 1994, JAFCO's president, Mr. Yoshida, decided to push JAV to enter the U.S. VC market. While he suspected that the densely networked U.S. VC industry would represent considerable barriers to entry for a foreign firm, he felt that JAV could provide unique services to prospective portfolio firms. Yoshida stated:

Between 1984 and 1990, we realized that you can only learn about VC in the U.S. by actually participating in investments and sweating through difficult situations in portfolio companies. We felt that we had a unique advantage over U.S. VC firms. We could provide potential portfolio companies with access to important distributors and customers in the world's second largest economy. Also, we could help portfolio companies find competent manufacturers. Finally, JAFCO had an excellent network within Asia. We decided to concentrate on information technology for three reasons. First, Japanese electronics and telecommunications firms were large and could be important lead customers and strategic partners for U.S. start-up firms. Second, Japanese electronics firms were reliable original equipment manufacturers (OEM) capable of producing large volumes of products at high quality levels. Third, other Asian countries where JAFCO had a dense network of contacts, such as Taiwan and Singapore, represented additional markets that were not immediately accessible for U.S. entrepreneurs.

In November 1994, JAFCO raised a ¥7 billion (U.S. \$70 million; US\$1=¥100 in 11/94) U.S. Information Technology Fund I from Japanese corporate investors, which included both operating and trading companies. The focus of this fund was balanced, including both early and late-stage investments in information technology firms in a broad sense (see Exhibit 9). Yoshida realized that in order to execute his investment philosophy of investing in U.S. companies, to whom JAFCO could provide unique value-added service, a team of qualified investment professionals would be needed. This team would bridge the geographical and cultural gap between Japan and the United States.

As a first step, in November 1994, Yoshida asked Jim Lu, a JAFCO employee, to transfer to JAV. Lu, of Chinese background, had been educated in Canada before joining JAFCO in Tokyo. He was fluent in Mandarin, English, and Japanese. At JAFCO, Lu had distinguished himself through a high level of analytical and coordination skills and a strong interest in Asian venture capital markets outside Japan. He knew many key employees at JAFCO well. As a second measure, Yoshida hired Marc Marsan to join Lu at JAV. Finally, Yoshida assigned Tanigawa as a key person within JAFCO's International Operations Department to provide value-added services to JAV's portfolio companies. While Shell, Lu and Marsan were based in San Francisco, Tanigawa continued to be based in Japan.

The compensation of Shell, Marsan, Lu, and Tanigawa was not comparable to that of partners of a U.S. VC firm, not even to one that, like JAFCO, did not have to raise its own funds. Shell had been hired for a representative and administrative role, and even after November 1994, his compensation

structure did not change. Lu, who had just transferred from JAFCO Tokyo, was not in a position to negotiate a substantial carry in deals as he did not have an individual deal-making record. Tanigawa continued to be paid a fixed salary, as were all of JAFCO's employees in Japan. Marsan, Lee, and Shell were compensated through a limited carry structure.

The team started working immediately. Between November 1994 and April 1996 they invested in 12 companies. By April 1, 1996, about \$21,715,000 (¥2,823,000,000: 130¥=1\$) would be invested, 7 companies were to go public and about \$49,850,000 (¥6,480,000,000: 130¥=1\$) would be realized. Among those portfolio companies was Ciena (February 1997) (see Exhibit 10), which had the largest market capitalization of any venture-backed IPO in history (\$2.7 billion at the IPO). Tivoli Systems went public and was later acquired by IBM in 1996.

JAV's value-added investment proposition proved to be successful with portfolio companies and gave JAV access to considerable deal flow. Todd Brooks, Principal, HBS '93, who joined JAFCO on April 10, 1995 from Franklin Templeton Funds where he worked as a telecommunications analyst stated: "Often U.S. startup firms have very little, if any, ability to tap into the overseas markets which often represent enormous revenue opportunities. If a startup firm inks a substantial contract with NTT or NEC, for example, that lends substantial credibility to U.S. customers and members of the U.S. financial community." In the case of Ciena, JAFCO's introduction led to the first large contract outside the United States. JAV not only picked up the tab for the U.S. entrepreneurs' trip to Japan and provided introductions, but also followed up with potential business partners in Japan after the visit. Andy Goldfarb, HBS '93 and Managing Principal at JAFCO stated: "Entering the Japanese market is complicated. Evaluating potential entry strategies, such as joint ventures versus exclusive or non-exclusive distributors, requires a lot of management time and detailed market knowledge. JAFCO, by leveraging our Japan connections, can accelerate this decision making process by getting direct feedback from potential Japanese partners. We also leverage our portfolio companies' management time by helping in the process. Our ability to deliver on the value-added proposition is critical to our future success."

The Shakeout

While JAV's entry into the U.S. VC market proved to be successful from an investor's point of view, there were two major problems: compensation and decision making. Standard industry compensation for fund managers who did not raise capital on their own was a 2.5% management fee plus 10-15% of the realized profits of the whole fund. By contrast, Lu and Marsan earned much lower compensation. In the beginning, Marsan and Lu were content with their compensation, as they did not have any independent investment track record. As JAV's first investments showed signs of a highly positive payoff, however, Lu and Marsan in particular started to question JAV's flat compensation structure. They approached management about this issue in 1995 but received a negative response.

Decision-making routines were a second problem for JAV's local management. All the investment decisions for JAV were made by JAFCO in Japan. JAFCO sought to apply the same decision making process that it used for its investment decisions in Japan and Europe to JAV. The investment committee consisted exclusively of JAFCO board members. This meant that Japanese managers with a limited understanding of the U.S. venture market had to make decisions on investments in potential portfolio companies. Furthermore, decision-making in Japan implied a longer time lag between the time a deal surfaced and a decision could be made. During this highly competitive period in the U.S. venture market, it took JAV eight weeks under optimal conditions to reach an investment decision while it took a local VC firm about two weeks.

Brooks stated: "The investment decision process at JAFCO would take three to four months from the point the deal showed up on JAFCO's radar screen. Furthermore, the JAFCO investment committee in Japan did not understand our deals and hardly ever met the entrepreneurs. In an increasingly competitive U.S. VC market, fast decision making is a competitive advantage that we lacked."

Lu and Marsan pushed for localized decision-making but were turned down by JAFCO. While Mr. Saitoh (JAV president) acknowledged the importance of local decision making, he felt that JAV's investment professionals did not have the appropriate track record yet. Lu and Marsan's dissatisfaction led them to contemplate leaving the firm. Todd Brooks observed: "The first week after I joined it was fairly clear to me that the people who had hired me were not too hopeful that things at JAV would change. I guess they were contemplating leaving the firm and they were just waiting for the right time."

In early April 1996, Lu and Marsan announced their decision to quit JAV. JAFCO's management was stunned. While aware of Lu and Marsan's dissatisfaction, managers had perceived it as highly improbable that they would leave. Around the end of April, Tanigawa quit JAFCO in Tokyo. In some ways this was an even bigger shock, as Tanigawa, a member of JAFCO's board, had been employed under a quasi-lifetime employment. In late April, Lu and Marsan started GlobalVentures, their own venture capital firm. GlobalVentures's strategy was to compete directly against JAV. The company opened an office in Palo Alto and quickly raised \$100M. In May 1996, Tanigawa and two of his JAFCO staff members, joined GlobalVentures and the company established an office in Tokyo.

Starting Over: Imuta-san's Challenge

JAFCO's president, Yoshida, knew he had to act quickly to stop the bleeding at JAV. On May 5, 1996 he called one of his most capable managers, Hitoshi Imuta, into his office. Imuta had been with Nomura Securities for 23 years before joining JAFCO in 1993. At Nomura, Imuta had worked for four years in New York City and three years in Singapore as president of Nomura Singapore, Ltd. At JAFCO he had most recently been a director in charge of the investment partnership administration and personnel departments. "We have to take action quickly," Yoshida said to Imuta. "I want you to join JAV as its new president. This is our second attempt at entering the U.S. VC market. Let's make sure we do things right this time."

While he was on the plane from Tokyo to San Francisco, Imuta considered the challenges ahead of him. In the short run, it was important to create a sense of security at current portfolio companies. Also, he would have to take a close look at the remaining JAV employees and identify those who could help him rebuild JAV. Beyond these immediate steps, however, Imuta knew that he needed to develop and communicate a vision for JAV and take critical first steps towards execution of this vision. Imuta knew that he had Yoshida's backing for radical changes at JAV.

Soon after arriving in the United States, Imuta concluded: "JAV's strategy to provide capital and added value for entrepreneurs seeking market entry and manufacturing in Japan and Asia was right. However, the incentives for execution of this strategy were not well aligned. JAV needs the best local decision makers who are adequately compensated."

In May 1996 Imuta decided to move JAFCO's U.S. headquarters office from San Francisco to Palo Alto and the East Coast office from New York City to Boston. "We have to be as close as possible to where the action is, and for information technology that is Palo Alto and Boston." In addition, Imuta and Todd Brooks focused on monitoring existing portfolio companies. Imuta also hired a headhunter

to find a new president. The headhunter "screened" 60 candidates and Imuta eventually met 6 of them; JAFCO's president Yoshida met the final three candidates. Imuta also involved JAFCO's current staff in his search. Imuta knew that the new leader would be crucial for JAV's success. In late August 1996, Schiffman signed a contract to start as the new president of JAV. Bob Shell left JAV that same month. Schiffman had spent his entire career in high tech growth companies and venture capital. In the mid-1980s, Schiffman joined Apple Computer as one of two partners who managed Apple's corporate venture program. Notable investments included Sybase, ON Technology and NetFrame. In 1993, Schiffman joined Weiss, Peck and Greer Venture Partners as a general partner, where he focused on early stage investments in information and communication technologies.

On October 18, 1996 Barry Schiffman became president and Chief Investment Officer of JAV and Imuta moved to become chairman of JAV. (See Exhibit 11, "JAFCO America Organization Chart.") Imuta reflected on his future challenges:

From May to October 1996, JAV made no new investments. We effectively lost a seven-month opportunity window. Now we are back on track. My role at JAV will be to keep associates and partners happy. Furthermore, I have to make sure that the communication flow between Japan and the U.S. is improved. Otherwise we cannot deliver on our value-added promise. Finally, I hope that I can transfer some of the knowledge I gained about managing a U.S. VC firm back to Japan. With the changes in Japan's financial markets and corporate governance system, JAFCO will have to change, too. The question is to what degree the U.S. is an appropriate role model for JAFCO in Japan.

Brooks decided to stay provided JAFCO made whole on its promises to change. Hiring Schiffman, he explained: "Was a clear sign that JAFCO was serious about making the right kind of change and provided me the confidence to stay."

For learning purposes, JAFCO would rotate one employee at a time, having them spend six months at JAV before returning to Japan.

Barry Schiffman Takes Charge

Immediately after taking over in October 1996, Schiffman made a number of important changes. First, Todd Brooks became a Managing Principal, then Schiffman introduced a tighter control system of internal operations and a monitoring system for portfolio companies. Previously, updates about portfolio companies had been reviewed and added to portfolio company files. Schiffman introduced a routine where new data were entered into financial planning models to update previous estimates. Schiffman also negotiated a simplification of the biannual reports to JAFCO. This saved JAV overhead.

Second, Schiffman made a number of hiring decisions. Andy Goldfarb, HBS '93, joined JAV as a Managing Principal to open the Boston office in April 1997. Goldfarb had previously worked for Trans National Group in Boston where he had set up Trans National's venture capital business. Phil Wickham joined JAV in March 1997 as an associate. Phil had previously been a Kauffman Fellow at OneLiberty Ventures in Boston. Goldfarb, Brooks and Wickham received carried interest in proportion to their VC experience. JAV's other employees received salaries plus performance bonuses.

Third, Schiffman instituted a new investment process. Whenever one of JAV's managers came across an interesting investment opportunity, they would write and circulate a one-page memo. If the investment prospects in the deal improved, this would be followed by a two-page memo and

eventually by a final investment memo (usually 10 pages plus appendices). The investment committee consisted of Barry Schiffman, Andrew Goldfarb, Todd Brooks, Hitoshi Imuta and one JAFCO employee from Japan who acted primarily as an observer. The small and localized investment committee enabled JAV to make decisions on very short notice. If required, JAV could now reach an investment decision 14 days after a deal showed up on its radar screen (see Exhibit 12 for a the investment decision making process at JAV).

Schiffman and Imuta also introduced a number of reporting routines including a weekly Monday morning (Pacific Time) meeting for which the Boston and Palo Alto offices were linked by video conferencing. This meeting was used to discuss all current issues, including the “investment funnel” of deals in early and late stages of evaluation. They also put one of JAFCO’s employees, Satoshi Yamaguchi, in charge of systematically establishing relationships with the U.S. subsidiaries of Japanese companies that could potentially add value to JAFCO’s portfolio companies. Schiffman reasoned that while key decisions about purchasing products from JAV’s portfolio companies were made in Japan, the Japanese firms’ U.S. subsidiaries could provide valuable direct contacts independent of JAFCO’s designated employees in Japan.

Reflecting on his first months at JAV, Schiffman stated:

I expected that I would have to perform all the tasks of somebody who starts over and that proved to be true. One big challenge I had not expected, though, was the issue of communications with JAFCO and with Japanese employees. I realized that I have to be very specific and clear in my communication with my Japanese counterparts. In the beginning I sometimes assumed that things were clear while they were not. I have made it a habit in our Monday meetings to proceed slowly and to make sure that everybody understands what we are talking about. That takes time but avoids trouble later.

Between October 1996 and July 1997, Schiffman refocused JAFCO’s investment activities to second- or third-round investments in information technology, namely software and communications companies. Venture-funded companies generally went through two to four successive rounds of financing before an initial public offering or a sale of the company to a strategic investor. Among other companies, JAV invested in Lightspan, Equator, Brocade and Vixel (see Exhibit 13A for a list of JAV investments). While he was busy changing the internal processes at JAV, Schiffman also focused on creating deal flow. In July 1997, JAV raised a \$100M fund to be invested across all stages.

VC firms co-invested in deals not only in order to share risk but also in order to get access to future deal flow. Board meetings of portfolio firms were the most important meeting platform for venture capitalists. The reputation of VC firm partners mattered a great deal and was easily tarnished by a number of under-performing investments. Information traveled quickly in the VC industry. Despite its economic importance, the industry consisted of only 610 firms in 1995.¹ Often, a VC firm that had invested in a promising portfolio company in the first round would invite selected other VC firms to invest in the second round not only because of the business expertise that these VC firms brought to the table but also in order to create goodwill among these VC firms and in order to get invited to co-invest in future deals. Also, VC firms sometimes invested in other VC firms’ funds in order to establish and strengthen relationships (see Exhibit 13B).

Schiffman reflected: “Creating a deal flow of high quality is crucial in this business. You do not want to waste your time on evaluating mediocre deals. But top VC firms generally use their top early-stage deals as bargaining chips, especially where the VCs have good information about the quality of the management team.”

¹ Source: Venture Economics Investor Services.

Schiffman found that JAV's value-added proposition of providing various forms of access to Japan and Asia was credible. There was, however, competition from GlobalVentures, the VC firm founded by Lu and Marsan. GlobalVenture's principals had a good track record and they could point to Tanigawa, their partner in Japan, as a credible provider of value-added activities. In the case of Sentient, a developer of multiservice switches for telecommunications carriers, JAFCO America initially competed with several other firms including GlobalVentures. In its third round of financing in March 1997, Sentient was looking to raise \$5–\$6 million; however, the firm was offered \$22 million from potential investors. The CEO of Sentient, Nimish Shah, knew Jim Lu of GlobalVentures very well. JAV had been invited to look at the deal by both Sequoia Capital and Sevin-Rosen, a VC firm that co-invested in the second-round financing. After careful consideration, Sentient decided to raise \$14 million. Sentient chose JAFCO as the lead investor for this round with Ameritech and AT&T as co-investors. Shah observed: "JAFCO was best situated to provide introductions to potential customers in Japan. They had the better reputation."

In March 1997, another JAFCO employee, Shinohara, who had provided value-added activities for JAV, left because of compensation and organizational issues. This once again raised Schiffman's concerns about JAFCO's ability to maintain JAV's value proposition. As his successor, JAFCO succeeded in recruiting Hiro Ikegaya, a very seasoned and experienced technology executive from Mitsubishi Corporation. At Mitsubishi, Ikegaya had been heavily involved with CISCO's early penetration of the Japanese market through a series of joint ventures with Mitsubishi subsidiaries. Ikegaya turned out to be an important resource, but he was very thinly stretched with an increasing demand for value-added activities.

Looking Forward: How to Compete?

Barry Schiffman knew that while JAV had made a promising start, there were important challenges ahead. First, there was the issue of competitive positioning of JAV. Over the last months JAV had focused on late-stage investments in information technology. As more money was flowing into the venture capital industry, it became expensive to invest in later stages. Schiffman was wondering to what degree JAV should push into first-stage investing, also called seed investing. He knew that seed investing required a better understanding of information technology than most of his professionals had. Furthermore, seed investing demanded very good people skills, time-intensive handholding of stressed-out entrepreneurs and sometimes drastic replacement decisions. Finally, he had to be careful not to position JAFCO as directly competing with the top-tier firms that historically provided JAFCO with its later-stage deal flow.

JAFCO had just announced that it had raised a second U.S. Information Technology Fund (USIT II), and Schiffman thought that this might be the right point in time to start seed-stage investing.

At this point, JAV was looking to hire one more partner with a good understanding of software technology. With the right person, Schiffman figured, the move into seed-stage investing would be easier. Another open question about seed-stage investing by JAV was whether JAV's value-added proposition would work as well for seed-stage investments as it did for later-stage investments. Did entrepreneurs who had just started their company really need to be introduced to Japanese customers and manufacturers? Schiffman could think of several examples among JAV's portfolio companies where earlier access to the Japanese market would have helped.

Second, there were new markets to be developed. Schiffman thought that Venture Leasing could be an interesting area for JAFCO. Venture leasing was a leasing contract where the lessee provided favorable leasing rates to the lessor against a certain stake in the lessor's entrepreneurial start-up.

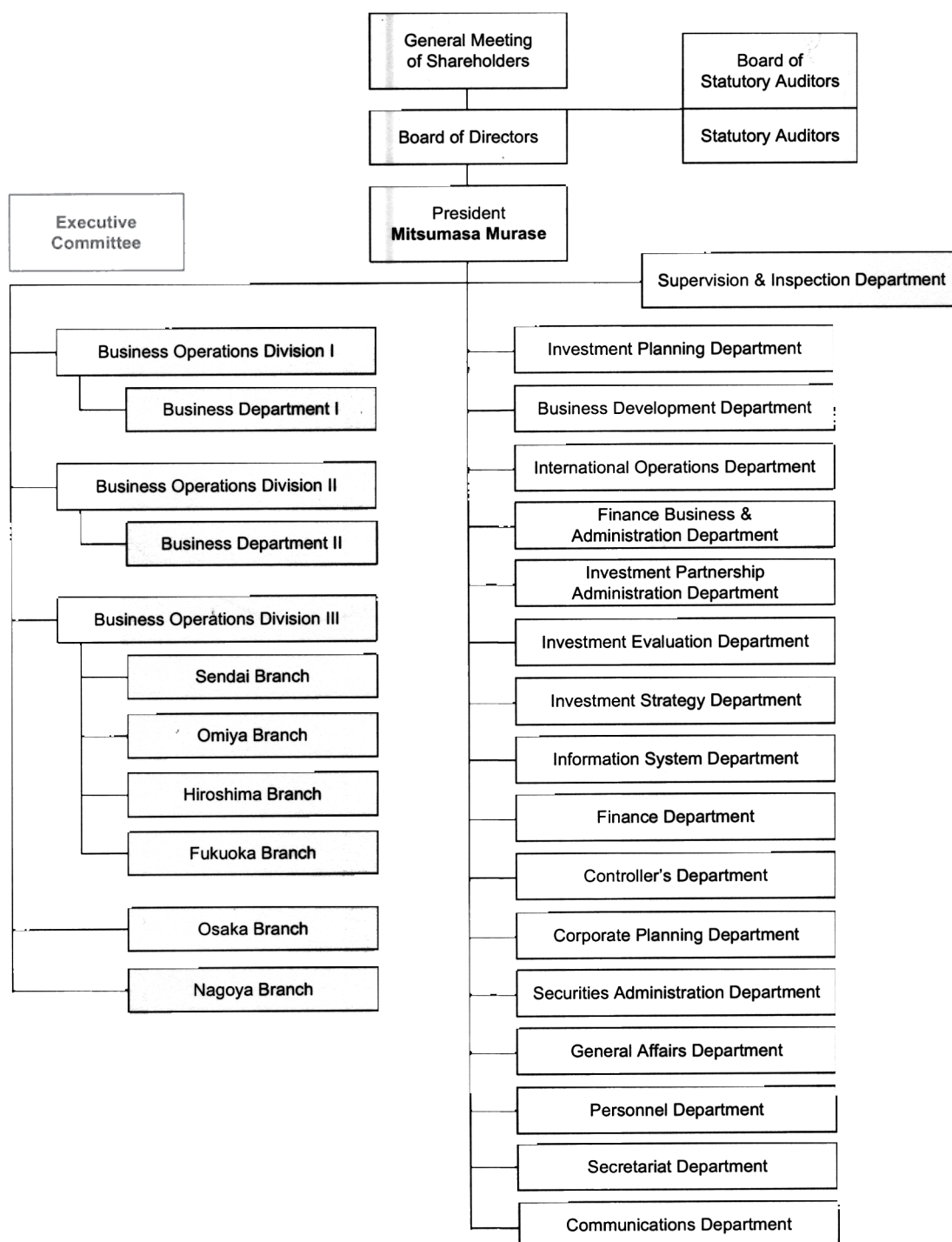
Schiffman had recently had a closer look at venture leasing and had assigned a summer intern to collect more data. Also, JAFCO's new president, Mitsumasa Murase, had mentioned to Schiffman that he would like to see JAV move into management buyouts and leveraged buyouts (MBOs and LBOs).

Third, there was the large life sciences market. So far, all of JAFCO's life science investments, even those in the United States, were still handled by JAFCO in Japan. JAFCO had a group of life science experts that was headed by Dr. Otaki, who was well connected to the pharmaceutical industry in Japan. JAV was currently looking to hire a senior person in the life sciences area. Schiffman envisioned this person to be responsible for making JAV rather than JAFCO the vehicle for life science investments in the United States. Once an appropriate partner had been identified, however, the question was how much control over life science investing Dr. Otaki and his group would relinquish. Schiffman wanted to avoid an internal fight since it was highly detrimental to JAV's value-added proposition. If the new partner was in conflict with Dr. Otaki, Otaki's group would probably be unwilling to provide introductions to JAV's life science portfolio companies. Schiffman made a note to talk to Imuta about this issue.

Then there was the burning issue of compensation of Japanese employees. Schiffman and Imuta knew that Tanigawa and Shinohara left JAFCO over issues of compensation and decision-making. It was only a question of time until other Japan-based JAFCO staff would become restless. A radical change in JAFCO's compensation structure for all of JAFCO's employees was not an option at this point. JAFCO acquired only small chunks of equity of its Japanese portfolio companies and employees bore virtually no risk. It would have been counterproductive to provide these employees with a windfall profit. But something had to be done about those employees who provided value-added activities to JAV. Schiffman knew that there was a system of a compensating highly qualified specialists outside of the general seniority system, particularly if they had been recruited from outside. Dr. Otaki was compensated under this system called "nenposei" and Schiffman was wondering whether it could be applied for Japanese staff in Tokyo, too.

Schiffman knew that the road ahead for JAV was challenging. At this point, only some of the internal management issues had been resolved. Also, there were a number of competitive challenges for JAV that needed to be addressed. As competition for the best deals in the VC market was heating up in 1997, JAV needed to continue building on its strengths. By this time, the bleeding at JAV had been stopped and things seemed to be moving in the right direction. But were they moving fast enough? Also, as the Japanese financial system was about to undergo a major deregulation in 1998, more opportunities for VC firms might open up in Japan and JAV's knowledge base about the U.S. VC industry was potentially very useful to JAFCO. The question was how to best transfer knowledge and skills to Japan. As Schiffman walked down the 16th fairway, he wondered how he should address all these challenges. These thoughts were definitely taking a toll on his golf score.

Exhibit 1 JAFCO (Japan), Inc. Organization Chart as of August 1997



Source: JAFCO.

Exhibit 2 JAFCO Consolidated Income Statements

'000s of US\$ except per-share amounts	1996	1997
Revenues from operational investment securities	165,718	166,129
Investment management fees	58,032	69,887
Consulting fees	9,411	10,581
Interest on operational loans	31,597	23,186
Other	5,774	7,282
Net revenues	270,532	277,065
Cost of operational investment securities	81,030	62,266
Financial costs, net	18,935	18,936
Other	14,672	8,371
Cost of revenues	114,637	89,573
Gross profit	155,895	187,492
Selling, general and administrative expenses	84,379	85,379
Operating profit	71,516	102,113
Income from interest and dividends	6,411	7,419
Interest expense	8,742	5,742
Other, net	1,992	(10,089)
Income before tax	71,177	93,701
Income tax	53,411	58,685
Equity in net losses of affiliated companies	4,250	
Net income	13,516	
Net income per share	0.28	0.55
Cash dividends per share	0.20	0.20

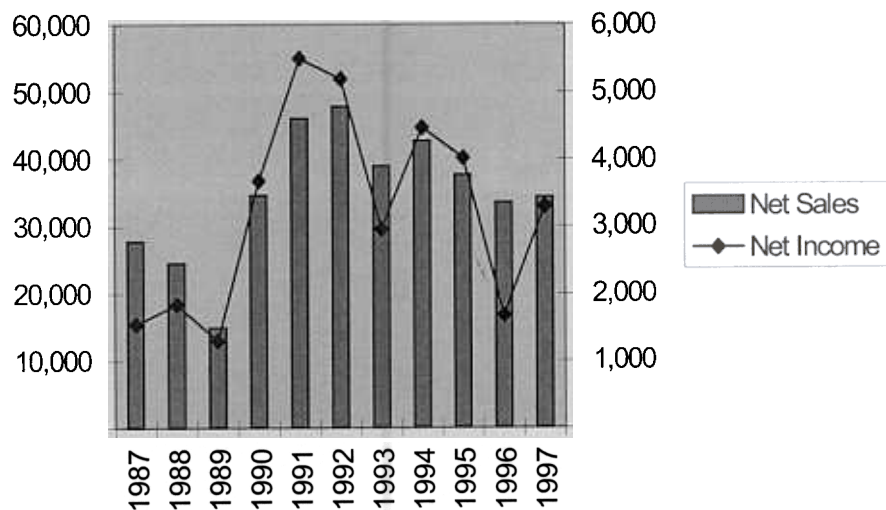
Source: JAFCO.

Exhibit 3 JAFCO Consolidated Balance Sheets

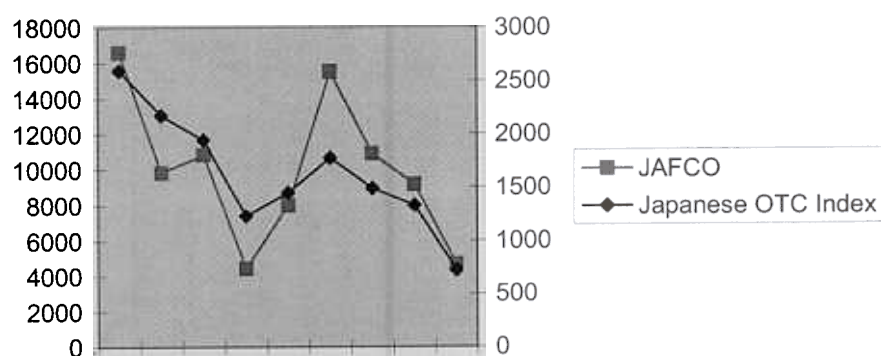
'000s of US\$	1996	1997
ASSETS:		
Cash and time deposits	47,484	36,670
Marketable securities	106,089	110,669
Short-term loans receivable	87,847	58,516
Operational loans, net	750,960	653,710
Operational investment securities, net	730,710	727,113
Prepaid expenses and other assets	32,355	41,693
Property, plant and equipment, net	158,097	160,992
Investments in affiliated companies	44,879	36,782
Other investments and other assets, net	288,565	367,000
Intangible assets and deferred charges	8,847	4,694
Total Assets	2,255,831	2,197,839
LIABILITIES:		
Short-term borrowings	804,234	660,419
Accrued income taxes	25,395	33,677
Accrued expenses and other liabilities	20,565	21,492
Long-term debt	652,444	711,186
Accrued retirement benefits	8,556	9,436
Total Liabilities	1,511,194	1,436,210
SHAREHOLDERS' EQUITY:		
Common Stock (80,000,000 shares authorized, 48,079,713 issued and outstanding)	264,444	264,444
Additional paid-in capital	260,371	260,371
Legal reserve	5,508	6,532
Retained earnings	214,855	230,395
Less—Treasury stock, at cost	(504)	(113)
Total Shareholders' Equity	744,637	761,629
Total Liabilities and Shareholders' Equity	2,255,831	2,197,839

Source: JAFCO.

Exhibit 4 JAFCO's Performance (Financial and Share Price)

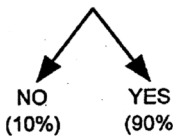
Financial Performance (figures in millions of ¥)

Source: JAFCO.

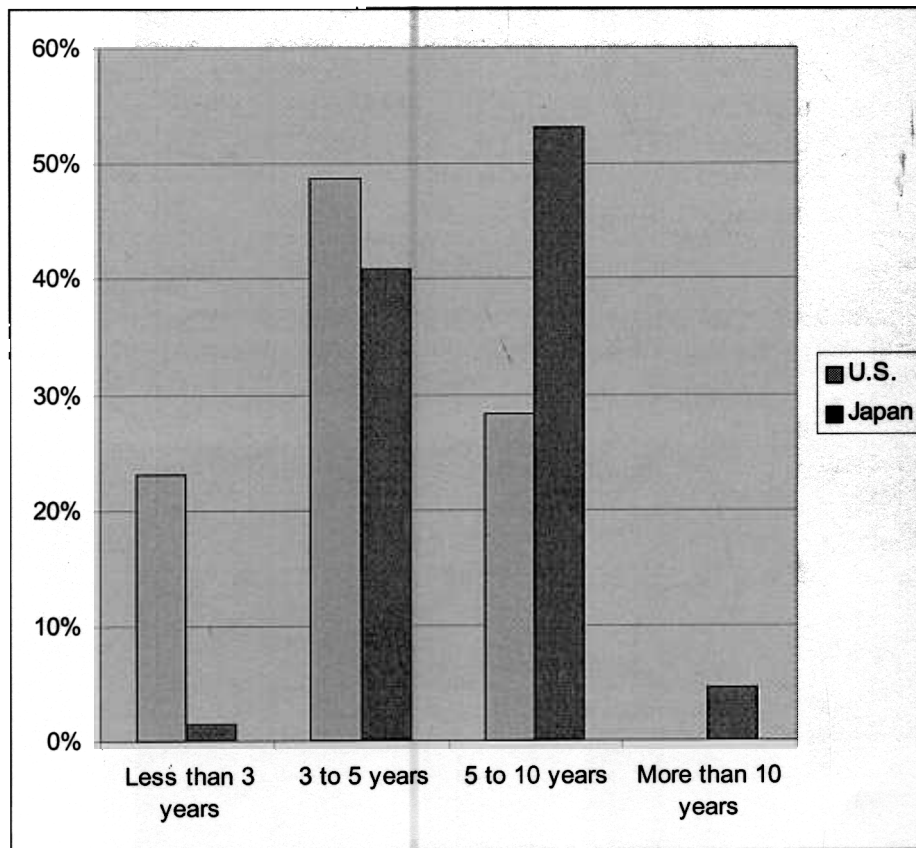
Share Price Performance

Source: Compiled from Thomson Financial Datastream data.

Exhibit 5 JAFCO's Japan Investment Decision-making Process (August 1997)

<u>Roles of the Investment Department Staff</u>	<u>Roles of Back-up Teams</u>	<u>Reports</u>	<u>Investment Committee</u>	<u>Date</u>
X = Investment Date				
Finding (# of Finding Team Members 120) Meeting with Top Management	Investment Strategy Dep -Market Research -Teamwork with Industry and Academia	Development Report Preference List		X-90
Due Diligence 1	Investment Planning Dep -Recommendations for Financial Strategy	Financial Policy Report Business Plan		
Due Diligence 2	Investment Evaluation Dep -Evaluation of Business Plan -Evaluation of Technology -Appraisal of Marketability -Evaluation of Top Management -Grading			X-45
		Evaluation Memo (4~5 pages)		X-15
Investment Decisions			JAFCO Investment Committee (15 Directors) (Meets Each Friday)	X
 NO (10%) YES (90% of proposals that reach this stage)				
Follow-up Value Added	Business Development Dep JAFCO Consulting JAFCO Asia Investment Service Other JAFCO Subsidiaries			
IPO Liquidation				

Source: JAFCO.

Exhibit 6 Period of Time Elapsed from Company Creation to IPO (U.S. vs. Japan)

Source: *White Paper on Small and Medium Enterprises in Japan*, 1997. Tokyo: Small and Medium Enterprises Agency (MITI), p. 375. (Translated from Japanese by casewriter. Original Japanese title: Chuushou Kigyō Hakusho.)

Exhibit 7 Investors in JAFCO America Venture Partners
(Fund raised in 9/1988)

Investor	US\$ Invested
Leeway & Co.	8,000,000
General Electric	5,000,000
HLM Management	5,000,000
Chemical Equity	3,000,000
Exxon	2,000,000
Hoechst Celanese	2,000,000
Stanford University	2,000,000
Caisse des Depots	1,500,000
Shingetsu II	1,200,000
Hewlett Packard	1,000,000
Westinghouse	1,000,000
Raytheon	1,000,000
MSVC Japan	1,000,000
Marrion Merrell Dow	1,000,000
Hancock International	1,000,000
Greylock	500,000
JAFCO America	<u>365,657</u>
Total	36,565,657

Source: JAFCO.

Exhibit 8 Investors in JAFCO America Venture Partners II
(Fund raised in 1994)

Investor	US\$ Invested
Leeway & Co.	17,000,000
Exxon	10,000,000
IBM	10,000,000
NYNEX	10,000,000
Allstate Insurance	4,500,000
Allstate Life Insurance	2,500,000
Allstate Retirement	1,700,000
Allstate Agent	1,300,000
Hancock International	5,500,000
Hancock International Asia	900,000
Hancock Venture	750,000
Hewlett Packard	2,000,000
Johnson & Johnson	1,000,000
JAFCO America	<u>678,283</u>
Total	67,828,283

Source: JAFCO.

Exhibit 9 USIT 1 Portfolio (August 1997)

Company	Shares	Avg. Cost Per Share	Total Cost	Liquidated to date (LTD)	Value of Unliquidated Securities	Total Market Value (LTD + Current Market)
AT/Comm	1,411	\$567.00	\$800,037	\$ -	\$800,037	800,037
Advanced Fibre Communications	585,879	\$6.83	\$3,999,996	\$ 25,890,720	\$ -	25,890,720
Brocade Communications Systems	637,139	\$3.45	\$2,199,998	\$ -	\$2,199,998	2,199,998
Cielo Communications	1,119,398	\$1.30	\$1,453,044	\$ -	\$1,453,044	1,453,044
Ciena	4,685,715	\$0.46	\$2,162,515	\$ 223,504,018	\$ -	223,504,018
CISCO/LightSpeed	973,913	\$1.64	\$1,600,000	\$ 11,120,000	\$3,582,811	14,702,811
Clear Communications	225,670	\$7.09	\$1,600,000	\$ -	\$1,600,000	1,600,000
Com21	333,857	\$2.52	\$840,260	\$ -	\$6,677,140	6,677,140
CommQuest Technologies	1,325,713	\$1.81	\$2,399,999	\$ 9,119,996	\$0	9,119,996
DynaChip	825,491	\$1.45	\$1,196,962	\$ -	\$1,196,962	1,196,962
Equator Technologies	620,104	\$3.40	\$2,110,676	\$ -	\$2,110,676	2,110,676
Etec Systems	541,599	\$4.88	\$2,643,003	\$ 15,104,381	\$ -	15,104,381
FlexiInternational Software	199,999	\$4.00	\$799,998	\$ -	\$799,998	799,998
IWC Holdings	74,920	\$6.67	\$499,750	\$ -	\$499,750	499,750
MMC Networks	422,640	\$2.65	\$1,119,996	\$ 9,513,840	\$1,252,800	10,766,640
NeoMagic	175,439	\$2.85	\$500,001	\$ 2,889,106	\$0	2,889,106
Network Integrity	579,852	\$2.95	\$1,711,645	\$ -	\$1,711,645	1,711,645
NVIDIA	944,889	\$2.01	\$1,894,560	\$ -	\$1,894,560	1,894,560
Objective System Integrators	636,363	\$11.00	\$6,999,993	\$ -	\$6,999,993	6,999,993
PSINet	240,965	\$4.15	\$1,000,005	\$ 2,262,302	\$ -	2,262,302
Pacific Monolithics	1,141,276	\$2.21	\$2,519,999	\$ -	\$2,519,999	2,519,999
PocketScience Inc.	1,280,486	\$1.63	\$2,092,309	\$ -	\$2,092,309	2,092,309
Sentient Networks, Inc.	456,491	\$7.01	\$3,200,002	\$ -	\$3,200,002	3,200,002
SmartMaps International	343,992	\$7.90	\$2,719,200	\$ -	\$2,719,200	2,719,200
Teleos Communication	350,000	\$3.22	\$1,126,385	\$ 1,251,512	\$ -	1,251,512
The Lightspan Partnership	851,062	\$3.76	\$3,199,993	\$ -	\$3,199,993	3,199,993
Vivid Semiconductor	890,380	\$2.25	\$2,000,097	\$ -	\$2,000,097	2,000,097
Vixel Corporation	888,888	\$4.50	\$3,999,996	\$ -	\$3,999,996	3,999,996
	21,353,531		\$58,390,418	\$ 300,655,875	\$52,511,010	\$353,166,886

Source: JAFECO.

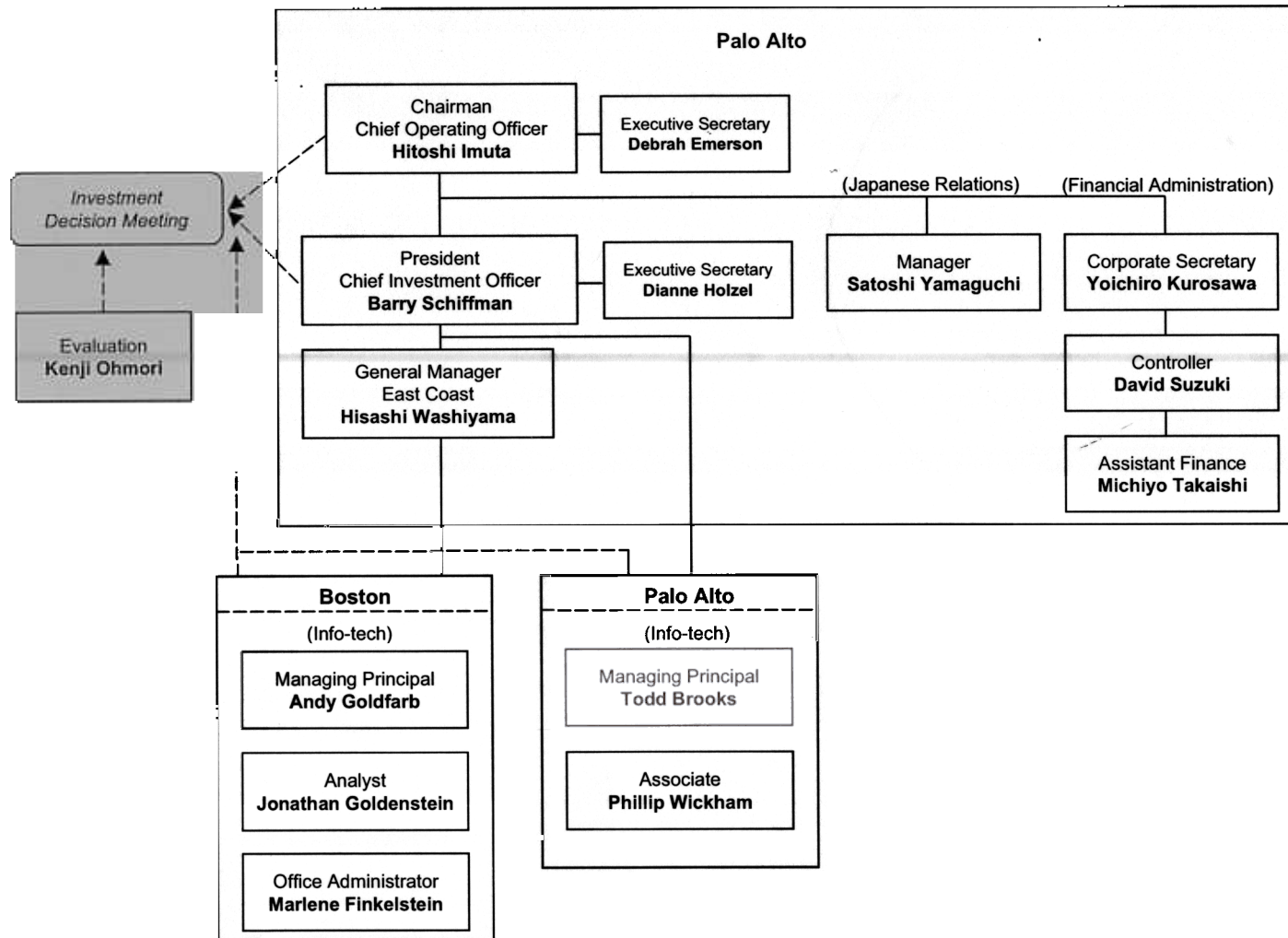
Exhibit 10 Capital Gains of Investments in USIT 1 (August 1997)

Company	Sales Proceeds	Cost Basis	Cap Gain/ Loss	Multiple	Time of Investment	Time of Exit	Holding Period
Advanced Fibre Communications	25,890,720	\$3,999,996	\$21,890,724	6.5x	3Q95	2Q97	1.75 years
Ciena*	223,504,018	\$2,162,515	\$221,341,503	103.4x	1Q95	2Q97	2.25 years
CISCO/LightSpeed	14,702,811	\$1,600,000	\$13,102,811	9.2x	1Q96	2Q98	2.25 years
CommQuest Technologies	9,119,996	\$2,399,999	\$6,719,998	3.8x	3Q95	2Q98	2.75 years
Etec Systems	15,104,381	\$2,643,003	\$12,461,378	5.7x	3Q95	4Q96	1.25 years
MMC Networks	10,766,640	\$1,119,996	\$9,646,644	9.6x	4Q95	2Q98	2.25 years
NeoMagic	2,889,106	\$500,001	\$2,389,105	5.8x	3Q96	4Q97	1.25 years
PSINet	2,262,302	\$1,000,005	\$1,262,297	2.3x	1Q95	3Q97	2.75 years
Teleos Communication	1,251,512	\$1,126,385	\$125,127	1.1x	2Q95	1Q97	1.75 years
Total Return	305,491,486	\$16,551,900	\$288,939,587	18.5x			2.00 years

Source: JAFECO America Ventures.

*Approximately 105 million of Ciena's sales proceeds were still held as marketable securities and had not been liquidated yet

Exhibit 11 JAFCO America Ventures, Inc. Organization Chart



Source: JAFCO America Ventures.

Exhibit 12 JAFCO America Ventures, Inc. Investment Decision Process

<u>Process</u>	<u>Action Involved in US</u>	<u>Reports Sent to Tokyo</u>	<u>Action Involved in Tokyo</u>	<u>Date</u>
X = Investment Date				
Finding	<ul style="list-style-type: none"> - Log in Business Plan - Review Deal Log at Weekly Staff Meeting 	Prospective Deal List		X-15
Due Diligence Level 1	<ul style="list-style-type: none"> - Evaluate Business Plan - Meet with Company Management - Technology/Market Analysis 	One Page		X-12
Due Diligence	<ul style="list-style-type: none"> - Ongoing Discussion with Company Management - Reference Check from 3rd Parties - Deal Negotiation 			
Investment Recommendation	<ul style="list-style-type: none"> - Formal Recommendation by Investment Principal 	<ul style="list-style-type: none"> - Business Plan - Product Profile 		
Investment Decision Meeting	<ul style="list-style-type: none"> - Meeting (Imuta, Schiffman, Investment Principal & Evaluation Dept. Staff) 	<ul style="list-style-type: none"> - Investment Outline Report - Investment Recommendation 	Deal Summary for Board of Directors	X-8
NO YES				
			Present to Board of Directors Meeting in Tokyo (every Friday)	X-5
		Investment Decision Report signed by Imuta & Schiffman	Portfolio Allocation Meeting (Wednesday)	X-2
	<ul style="list-style-type: none"> - Deal Closing 		Signing on Legal Document	X

Source: JAFCO America Ventures.

Exhibit 13A List of all Past and Present JAFco AV Portfolio Companies

Company Name	Date Invested
Calgene	1/9/85
Foothill Research, Inc.	4/18/86
Empress Foods	7/7/86
Attain	8/25/87
Microgenics	9/24/87
Novellus Systems	1/29/88
Biomagnetic Technologies	8/23/88
C-Cube Microsystems	1/20/89
Synergy Semiconductor	7/25/89
Circle C Trucking	9/26/89
Metalaser Technologies	11/17/89
INMET	1/11/90
EMC	1/30/90
Aehr Test Systems	2/26/90
Endosonics	3/20/90
Cephalon	5/17/90
Netrix	5/31/90
FileNet Corp.	7/5/90
KVA Holding Corp.	11/15/90
Liant Software	1/24/91
Isis Pharmaceuticals	3/15/91
Oclassen Pharmaceuticals	3/15/91
United Biomedical	5/2/91
IGEN	6/13/91
Gensym	7/30/91
BMC West	9/30/91
Alton Geoscience	10/9/91
ADAPTEC	2/7/92
Advanced Computer Communications	2/7/92
Gliatech	2/24/92
Immunopharmaceutics	4/30/92
Netwise	7/22/92
NPS Pharmaceuticals	8/10/92
Network Computing Devices	11/6/92
Tivoly Systems	12/1/92
SyQuest Technology	12/16/92
Retix	4/7/93
AntiCancer	5/31/93
Avigen	6/30/93
Synernetics	1/24/94
Cyrix	1/26/94
Crystalline Materials	1/26/94
Metatools	1/26/94
OsteoArthritis Sciences	3/25/94
PSINet	6/17/94
Micronix	6/26/94
NeoMagic	7/6/94
Com21	9/9/94
International Wireless Communications	10/7/94

Company Name	Date Invested
Nvidia	12/16/94
Ciena	2/3/95
Thesis	3/31/95
First Medical	6/21/95
ComQuest Technologies	6/30/95
AT/Comm	7/8/95
ParcPlace Systems	8/4/95
Wireless Access	8/16/95
Etec Systems	8/30/95
VTEL	9/7/95
Objective Systems Integrators	9/22/95
Advanced Fibre Communications	9/29/95
MMC Networks	11/14/95
AIT Delaware	12/15/95
Slate	12/29/95
Network Integrity	2/20/96
LightSpeed International	2/29/96
Citrix Systems	3/13/96
Teleos Communications	4/2/96
Sega Gameworks	4/5/96
Cyberonics	4/8/96
Ribozyme Pharmaceuticals	4/11/96
Clear Channel Communications	4/26/96
Pacific Monolithics	5/28/96
Vivid Semiconductor	7/12/96
International Wireless Communications Holdings	8/9/96
BENCHMARK MICROELECTRONICS	9/9/96
Chromagen	10/4/96
Vixel Corporation	10/11/96
CombiChem	11/7/96
Brocade Communications Systems	12/6/96
Texas Biotechnology	12/17/96
Aurora Biosciences	12/20/96
Kinetix Pharmaceuticals	2/7/97
Fibermark	2/17/97
TriQuint Semiconductor	2/24/97
FlexiInternational Software	2/26/97
PocketScience Inc.	2/26/97
Micronics Computers	2/27/97
SmartMaps International	3/21/97
Sentient Networks	3/26/97
Sepracor	5/16/97
Spectrian	5/30/97
DynaChip	6/13/97
Lucent Medical Systems	6/23/97
The Lightspan Partnership	6/24/97
Equator Technologies	6/27/97
Calimetrix	8/6/97

Source: JAFCO.

Exhibit 13B JAFCO Investments in Other VC Funds

Company Name	Date^a
Weiss, Peck & Greer Venture Associates, L.P.	11/30/84
Sevin Rosen Fund III	08/27/87
Philadelphia Venture Japan I	10/08/87
MDC/JAFCO Ventures	12/07/87
Philadelphia Venture Japan II	01/18/89
Hummer Winblad Venture Partners II	08/12/93
North Bridge Venture Partners	07/13/94
Sevin Rosen Fund V	10/23/95
Sequoia Capital VII	10/28/95
Vanguard Ventures V	02/29/96
Doll Technology Investment Fund	10/28/96
Forward Venture Partners	02/18/97

Source: JAFCO.

^aDate of first capital call.