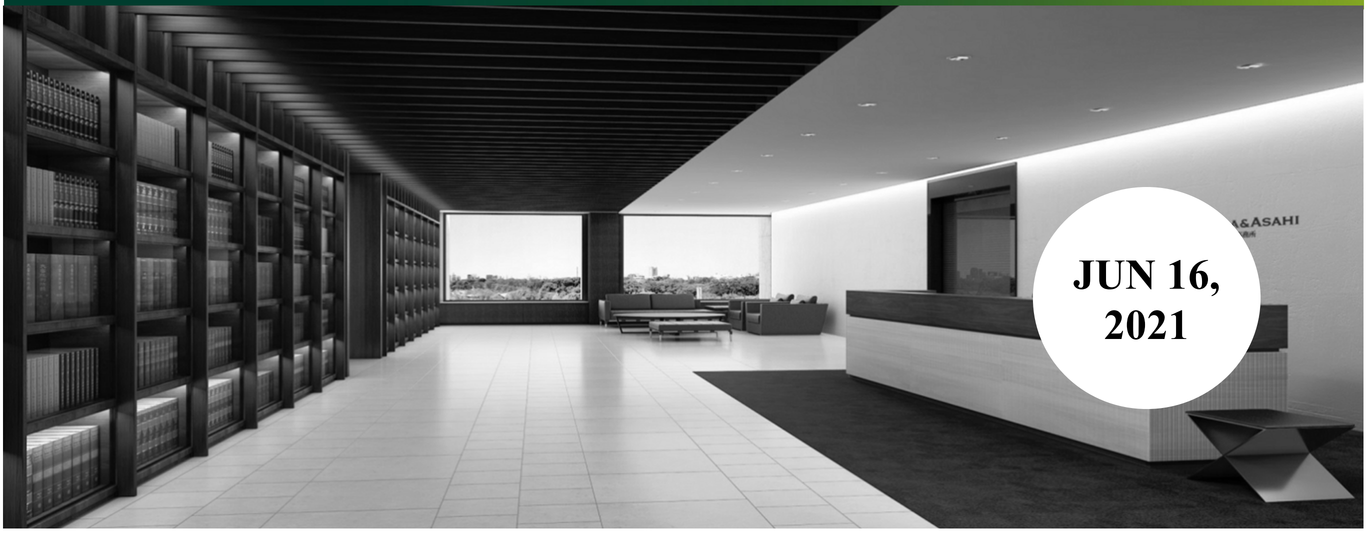
西村あさひ法律事務所

NISHIMURA & ASAHI

# Finance Law Newsletter




## Legal Considerations in Financing Japanese Aquaculture (Part 2)

Yasunari Sugiyama, Naoki Matsumoto, Kenya Suzuki

The Act for Partial Amendment to the Act on Special Measures to Facilitate Investment in Agricultural Corporations (hereinafter referred to as the "Investment Facilitation Act" and Investment Facilitation Act, as amended being referred to as the "Revised Investment Facilitation Act") was promulgated on April 28 of this year, bringing with it new approved methods for financing aquaculture business. Taking these changes into consideration, this newsletter reviews the methodologies most suitable for use by financial institutions in investing aquaculture related undertakings, including recourse and payment sources and investment targets (i.e. operators or asset owners), before discussing schemes that can be formed under the current legislation.

### I Aquaculture Business Finance Methods

### 1. Debt/equity investment methods (debt financing or equity financing)

There are generally two methods of investment by financial institutions: debt financing and equity financing.
Debt financing consists of financing through borrowings and bonds including (secured) loans from banks, money lenders, and other financial institutions.
Equity financing consists of the issuance of shares and partnership investment, including equity contributions from financial institutions, funds and operating companies, and *tokumei kumiai* (silent partner) investments.
The Investment Facilitation Act mainly covers equity financing, but the Revised Investment Facilitation Act stipulates that “fishery business” has been added to the scope of the law and that enforcement thereof shall be stipulated by cabinet order within six months from the date of promulgation. Under the Investment Facilitation Act (prior to the amendment), a stock company (hereinafter referred to as an "Approved Company") or Investment Limited Partnership (*toshi-jigyo-yugen-sekinin-kumiai*: hereinafter referred to as an "Approved Partnership"), approved by the Minister of Agriculture, Forestry and Fisheries to provide investment and management guidance to an agricultural corporation, was permitted to receive investment from the Japan Finance Corporation (Article 8 of Investment Facilitation Act), and private financial institutions were able to diversify their investment risks and contribute to the agricultural corporation through investment in such Approved Company or Approved Partnership. The Revised Investment Facilitation

Act added facilitation of investments in fisheries (Article 1 of Revised Investment Facilitation Act), incorporating fishery corporations as targets for Approved Company or Approved Partnership investment (Article 3 of Revised Investment Facilitation Act, Article 2, Paragraph 2, and Article 2, Paragraph 1, Item 3). This could also allow financial institutions to diversify into fishery corporations through an Approved Company or Approved Partnership and could be a significant boost to financing fisheries.[1]

## 2. Debt/equity investment recourse and reliance (Liquidation Value of Aquaculture Facilities or Cash Flow of Aquaculture Businesses)

### (1) Asset finance

Asset finance is financing that relies on the liquidation value of the assets upon which the financing was based. In regard to aquaculture business, such collateral could include aquaculture facilities, vessels used for sea culture, underwater drones, and other equipment. Financial institutions may provide loans in an amount commensurate with the liquidation value of these facilities and equipment, purchase the items themselves and lease them to the aquaculture business operator, or utilize some combination of similar arrangements.

### (2) Project finance

Project finance refers to financing for a particular project in which the source of repayment/distribution is limited, in principle, to the cash flows from the project. It differs from asset finance in that it does not rely on the liquidation value of a particular asset, but rather the project's projected cash flows.

Assets held by aquaculture business operators often include items that are difficult to resell to third parties, such as nets and rafts, and uniquely situated real estate. Moreover, land-based aquaculture facilities do not have high liquidation value compared to office and residential buildings. If the financiers focus only on the liquidation value of assets, such as in asset finance, the low valuations of such items would make it difficult to establish sufficient collateral, and thus difficult to obtain financing that covers the entirety of aquaculture business costs. Therefore, the use of a project finance methodology is worthy of consideration if seeking a loan size greater than the liquidation value of the assets alone may justify.

## 3. Targets of debt/equity investment (aquaculture business operator or aquaculture asset owner)

Debt/equity investment for domestic and overseas aquaculture businesses can be broadly classified into two categories: (1) those in which the aquaculture business operators own the necessary assets to operate an aquaculture business and seek to raise funds in support of such operation, and (2) those in which separate operators and asset holders partner and seek to raise funds.

### (1) If the asset holder and the operator are the same (the asset holder-operator)

First, in the event that the asset holder-operator is exclusively engaged in aquaculture business within a specified zone or facility (hereinafter referred to as the "Target Aquaculture Business"), the investor will only recover the investment from the assets related to the Target Aquaculture Business owned by the asset holder-operator and the cash flow generated from the relevant business. Therefore, the investor will directly bear the risk of whether or not the Target Aquaculture Business will be successful.

On the other hand, if the asset holder-operator is engaged in several aquaculture and other businesses, the risk borne by the investor is as follows.

[1] As of October 1, 2020, the sole Approved Company was Agribusiness Investment & Consultation Co., Ltd., and its shareholders were rather limited. However, then there were 22 Approved Partnerships with diverse memberships, and investment through such existing and newly established Approved Partnerships will gain acceptance as a realistic option for financial institutions.

**(a) Segregation of recourse assets of the Target Aquaculture Business from other businesses**

In this case, as in the case of investing in the aforementioned aquaculture company only engaging in the Target Aquaculture Business, investors will, in principle, bear the risk of success or failure of the Target Aquaculture Business. However, if bankruptcy proceedings are commenced against the asset holder-operator, assets related to the Target Aquaculture Business may also be included in the bankruptcy estate, or the asset holder-operator's entire outstanding loan balance may be suspended or rescheduled. Therefore, it should be noted that risks associated with other businesses of the asset holder-operator may also be borne by investors of the Target Aquaculture Business.

**(b) Aggregation of recourse assets of the Target Aquaculture Business with those of other businesses**

In this case, the investor will be reimbursed from the cumulative cash flow of the asset holder-operator's entire line of businesses, but also will bear the risks associated with the asset holder-operator's businesses other than the Target Aquaculture Business, so the relevant investment procedures will be similar to those of typical corporate finance; that is to say, they will pend the creditworthiness of the asset holder-operator.

In addition, if the asset holder and the operator are the same, both debt investors and equity investors will bear the risk of the Target Aquaculture Business. Nevertheless, while equity investors can enjoy the upside of earnings from the Target Aquaculture Business through dividends, debt investors basically receive only a fixed or floating amount of interest income and fees. Therefore, debt investors will not want to bear project risk to the same extent as equity investors, making it common for the prior to take measures such as preparing an equity cushion to increase the equity investor's portion of the investment in proportion to the greater risk.

**(2) If the asset holder differs from the operator**

In such scenario the asset holder leases the aquaculture business assets (after acquiring or constructing them utilizing funds provided by the investor) to the operator (typically engaging in several similar or different businesses) and the asset holder makes debt repayment and distributions to the investor from the moneys obtained in the form of lease payments from the operator.[2]

In this case, the risk borne by the investor varies depending on whether the lease payment is fixed (i.e. of a set or guaranteed minimum amount), or variable (i.e. fully or partially performance-based). In the event that fixed or minimum lease payments are required and the operator is a creditworthy operating company or there is credit enhancement or other support from a sponsor (similar to a guarantor), the investor does not accept risk to the extent that the payment of the fixed or minimum lease fee is secured (guaranteed). In such cases, the investor's ability to recover the investment will depend on whether the lease payment can be covered by the combined resources/assets of the operator (including other businesses they may control) and the sponsor (i.e., depending on the operator's and the sponsor's creditworthiness. On the other hand, if the lease payments are entirely performance-based, the lease payments, which are the source of repayment/distribution, will fluctuate directly with the performance of the Target Aquaculture Business, so investors will bear the risk of the Target Aquaculture Business. In addition, if the lease payments consist of both a fixed portion and a performance-based portion, the risk allocation and profit ratio can be adjusted by making the fixed portion, which is more likely to be repaid, the source of repayment for the debt investors and the performance-based portion the source of distribution for equity investors.

In this way, aquaculture business schemes can take a variety of forms, but it is understood that aquaculture businesses should be assessed on a case-by-case basis in which consideration is given to the size and scope of the business, the type and business potential of the Target Aquaculture Business, and the attributes and intentions of associated debt/equity investors.

---

2 If an operator only engages in the Target Aquaculture Business, it is not necessary to consider the risk of other businesses, nor to arrange asset holders separately.

## II Asset finance approach

From the perspective of asset financing that relies on the liquidation value of target assets, specific methods of providing financing include secured loans, leasing transactions, and factoring.

### 1. Secured loans

The secured loan is a financing method that appraises the liquidation value of assets such as aquaculture facilities, cultured fish, and accounts receivables owned by the asset holder. The loans are provided based on to the appraised value of the assets, upon which security interests are created.

The types of security interests are different for each target asset, and an outline thereof are as follows.

| | Security Interests | Requirements for Perfection |
|---|---|---|
| Aquaculture facilities (real estate) | Mortgage | Registration |
| Aquaculture facilities and devices (movable asset) | (i) Security assignment of movable assets<br>(ii) Ship mortgage in the case of a ship | (i) Delivery (possession) or movable asset assignment registration<br>(ii) Registration of ship mortgage |
| Cultured fish in a harvest cage | Security assignment of movable assets | Delivery (possession) or movable asset assignment registration |
| Accounts receivable | Pledge or security assignment of claims | Notice to the obligor on which fixed date is stamped, acknowledge of the obligor on which fixed date is stamped or registration of assignment of claims |
| Fishery right | Mortgage | Registering with licensed fishery register (*menkyo-gyogyo-genbo*) |

In addition, when creating security interest on cultured fish, the following issues may arise, making it is necessary to take the noted appropriate measures (below).

| Issue | Measures |
|---|---|
| Evaluation method of cultured fish as collateral | In some cases, financial institutions have limited expertise in valuation of cultured fish as collateral. In such cases, assessment may be entrusted to an outside supervisor with specialized knowledge, such as a sales company of cultured fish. |
| Method of monitoring cultured fish during the loan period | A covenant to provide monthly reporting by the aquaculture business operator as borrower may be set forth in the loan agreement. In addition, if there is a production management system used by the aquaculture business operator, the information gathered in the system may be shared with financial institutions. It is also possible to grasp the growth and abundance of cultured fish by cooperating with feed suppliers and cultured fish distributors. |
| Method to dispose of cultured fish | The timing of cultured fish disposal (e.g., growth of cultured fish and the risk of falling prices by releasing large quantities of cultured fish in the marketplace) requires careful judgment. Therefore, it is desirable to obtain prior cooperation from sales companies with specialized knowledge. In some cases, a certain period of development may be required before cultured fish can be shipped. Therefore, it is possible to select a subcontractor for such development in advance. |

## 2. Lease transactions

Leasing transactions are financing methods through which a leasing company or a special-purpose company established by a leasing company acquires assets, such as aquaculture facilities, vessels and underwater drones used for aquaculture, and leases them to the operator. Both finance leases which recover the cost of acquiring an asset by lease payments during the lease term and the residual value at the end of the lease term, and operating leases which do not qualify as finance-lease transactions, are considered to fall in this category.

In addition, lessors may finance asset acquisition funds through loans from financial institutions, and in such a case, issues similar to those described in '1' (above) are expected to arise.

In a lease transaction, if the lessee defaults, the lessor will recover the investment by selling the leased asset or re-leasing it to another operator. Therefore, lease transactions can be regarded as financing methods suitable for assets for which a used market is established and for assets that can be inherited and used even by other aquaculture business operators.

## 3. Factoring

Factoring is a financing method to accelerate the encashment of accounts receivables that an aquaculture (or any) business operator is owed by an off-taker (i.e. purchaser of project outputs), in cases where the operator enters a continuous sale and purchase agreement with the off-taker, and sells its rights (to profits) in such agreement to a factoring company (who then collects the full accounts receivables owed under the agreement and thereby makes a profit).

We will explain the 'project finance' approach in the next newsletter.

(Following to Part 3)

Yasunari Sugiyama
Partner, Nishimura & Asahi
y.sugiyama@nishimura.com

Yasunari Sugiyama is a partner in the firm's asset finance group and his major and unique areas include the financing of movables, the debt/equity investment to agri-food business, the domestic and cross-border real estate transactions and the supports for overseas expansion by financial institutions. In particular, he recently aims to provide the legal services for the purposes of the introduction of smart agriculture, the investments and M&As regarding domestic and overseas agri-corporations and diversification of financing sources while organizing the various laws and regulations applicable to each phase of farming, plant factory and aquaculture business.

Naoki Matsumoto
Attorney-at-Law, Nishimura & Asahi
na.matsumoto@nishimura.com

Naoki Matsumoto is an associate in banking and finance practice group at Nishimura & Asahi. He specializes in project finance and asset finance transactions.

Kenya Suzuki
Attorney-at-Law, Nishimura & Asahi
ke.suzuki@nishimura.com

Kenya Suzuki is an associate attorney at Nishimura & Asahi, specializing in agri-food business debt/equity investment. He also handles asset finance transactions, project finance transactions, and financial regulations.

**Public Relations Section, Nishimura & Asahi**
Otemon Tower, 1-1-2 Otemachi, Chiyoda-ku, Tokyo 100-8124, JAPAN
Tel: +81-3-6250-6202 Fax: +81-3-6250-7200 E-mail: newsletter@nishimura.com URL: https://www.nishimura.com/en