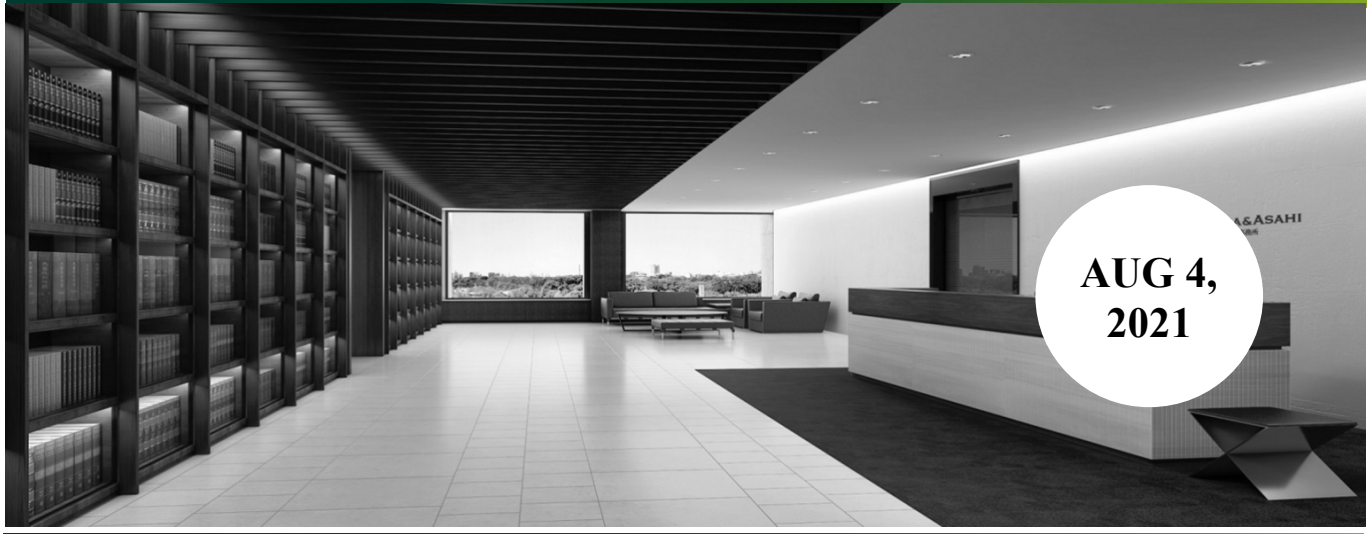


Finance Law Newsletter



Legal Considerations in Financing Japanese Aquaculture (Part 3)

Yasunari Sugiyama, Naoki Matsumoto, Kenya Suzuki

This issue examines the possibility of project financing for aquaculture business and the assumed scheme.

Project finance approach

1. Sea Level and Inland Waters Culture Compared with Land Aquaculture from the Project-Financing Perspective

As project financing repayment/distribution sources are limited to a project's cash flow, financial institutions will not obtain full loan repayment unless the project generates the anticipated revenue. In this sense, it can be said that financial institutions bear the risks inherent in projects (project risk). Therefore, project financing requires to manage project risk that is within the acceptable range of the financial institution.

One of the characteristics of project financing is that in the event of a deterioration in project earnings and the borrower's default, financial institutions do not necessarily collect receivables by selling or realizing the collateral property, but rather can collect receivables by transferring all the rights and contractual relationships of the project to a third party (mainly assuming a company under the control of a new sponsor invited by a financial institution) and revitalizing and continuing the project under the new sponsor (so-called "step-in"). Therefore, the feasibility of smooth step-in is an important factor in examining the appropriateness of project finance.

From the above viewpoints, when comparing sea level and inland waters culture with land-based aquaculture, each has its own notable characteristics (as shown in the table below). Generally speaking, given its greater predictability, land-based aquaculture enthusiasts have greater affinity with project finance compared to those interested in sea level and inland waters culture, but the latter

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are developing and introducing new technologies for feeding management, analysis of fish herd behavior, and control of marine data (water temperature and generation of red tide, etc.) that are increasing sea level and inland waters culture predictability and establishing conditions precedent for project financing.

	Sea level and inland waters culture	Land aquaculture
Demand for funds	When introducing advanced and large-scale equipment, it is assumed that the initial investment cost will be high.	It is assumed that the initial investment cost will be high, and the demand for funds using project finance can be generated. In addition, the construction period of aquaculture facilities may be long, and how to cover the costs during construction is a problem.
Project risk (cash flow stability)	<ul style="list-style-type: none"> • Susceptible to natural environments (natural disasters, outbreaks of red tides, spread of infectious diseases, etc.) → Possibility of avoidance actions by analyzing marine data • Catch period may be limited to a specific period → Reduction of breeding period by optimization of feeding, etc. 	<ul style="list-style-type: none"> • Establishment of closed facilities prevents typhoons and flood damage, thereby avoiding and mitigating the risk of natural disasters • Cash flow can be stabilized and leveled by adjusting the hatching, growing and shipping times of fish according to production plans
Step-in	Demarcated fishery right is required for the implementation of the project, and the approval of the prefectural governor and hearing the views of the Sea-area fishery Coordination Commission are required when mortgaging the demarcated fishery right and when stepping-in by executing the mortgage (Clauses 2 and 3 of Fishery Act Articles 78 and 79).	Because a demarcated fishery right is not required for project implementation, step-in procedures need not be taken into account for the transfer of licences to new sponsors.

2. Various indicators that investors should watch

Because project financing is a cash flow-based financing method, the Debt-Service Coverage Ratio (hereinafter referred to as “DSCR”) is used as one of the main financial indicators.

DSCR is the ratio equal to (i) the operating cash flow of a project for a given calculation period divided by (ii) the sum of the principal and interest of the loans payable during the same period. If DSCR exceeds 1.0, it means that the cash flow from the project acquired by the Borrower over that time exceeds the loan repayment requirement and the loan can be repaid by the Borrower. It is common for the lender to set a minimum DSCR requirement, taking into account the expected cash flow and project risk for each project, and to cause the borrower to covenant to maintain DSCR above that minimum requirement over the project period. In addition, financial measures such as those shown in the table below may be used as financial covenants or reportable in order to ascertain profitability, solvency and liquidity. Moreover, financial covenants and related provisions in acquisition financing such as LBOs may be referenced.

Net farm Income
ROA (rate of return on assets)
ROE (rate of return on equity)
Financial leverage ratio (ROE ÷ ROA)
Operating profit margin ratio (Operating profit ÷ total revenue ×100%)
Debt/asset ratio (Total liabilities ÷ total assets)
Equity/asset ratio (Net worth ÷ total assets)
Debt/equity ratio (Total liabilities ÷ net worth)

Current ratio (Current assets ÷ current liabilities)

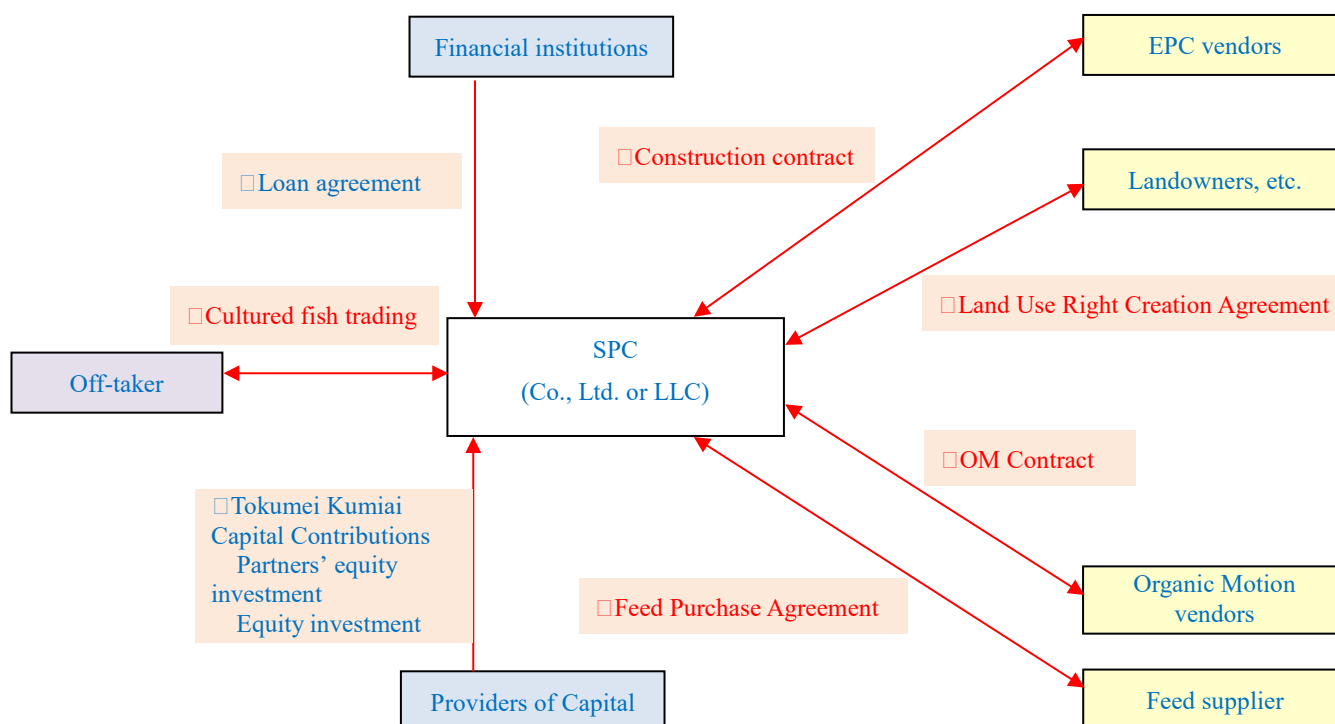
In addition, the following indicators can be used to determine the production efficiency specific to the aquaculture business.¹

Indicator	Calculation Formula
FCR(feed conversion ratio)	(Weight of feed fed) ÷ (weight of fish sold)
Fish production per 1,000 fingerlings stocked (fingerling efficiency)	(Weight of fish sold) ÷ (number of fingerlings stocked) ÷ 1000
Fish production per dollar of working capital (operating capital efficiency)	(Weight of fish sold) ÷ (working capital)
Fish production per worker (labor efficiency)	(Weight of fish sold) ÷ (number of acres) ÷ (FTE of labor) FTEs = (total months of labor) ÷ 12
Cost of Production	(Total costs) ÷ (weight of fish sold)
Stocker turnover ratio	(Total biomass on farm) ÷ (sales) × 365 days

3. Assumed Structure for Financing for Operator

(1) Structure overview

The (land aquaculture) structure of project financing for operators may include the following:



- (i) A special-purpose company (generally a joint stock company or limited liability company) is established as an operator into which equity investors make investments.
- (ii) The lender provides project-finance loans to the operator.
- (iii) With investments from equity investors and project finance loans from lenders, the operator enters into agreements for the

¹ Carole R. Engle “Aquaculture Economics and Financing Management and Analysis” on page 42 and following (WILEY-BLACKWELL Co., Ltd.).

establishment of rights to use the leased land for aquaculture facilities, agreements for the construction of aquaculture facilities, and other agreements required for the construction of aquaculture facilities, and accordingly owns the resultant aquaculture facilities.

- (iv) Operator enters into agreements for the outsourcing of aquaculture, the outsourcing of the maintenance of aquaculture facilities, the purchase of feed, and other related agreements required for the operation of projects after the completion of aquaculture facilities.
- (v) When aquaculture fish become available for shipment, operator will sell the aquaculture fish to the off-taker, use the proceeds from the sale to pay project operating costs, reimburse project financing loans and distribute the proceeds to equity investors.

The construction period of the aquaculture facility will take a certain project-dependent lead time, and there will be a risk that the construction of the aquaculture facility will be delayed or that the construction of the facility will not be completed at the anticipated project cost. In addition, aquaculture facilities are often located remote from urban areas, and it is difficult to provide financing during the construction period relying on site prices (such as development-type real estate securitization projects). Currently, in order to avoid such risks, it is common to finance during the construction period through corporate finance relying on the credit of the aquaculture business operator and sponsors, and equity investment by aquaculture business operator and sponsors, and to implement financing after aquaculture facilities have been completed. Provided, however, that loans may be provided during the construction period depending on the individual project, taking into account the performance of the aquaculture facility builder, creditworthiness and completion guarantee, insurance coverage during the construction period, and equity investment ratio of equity investors.² Rather, aquaculture business operators expect to use project finance loans as a source of funds to pay project costs that arise from time to time during the construction period, such as interim advances to builders.

(2) Security packages

Security interests in project finance are established primarily for the purpose of preventing the loss of the assets required for the project by a third party by pledging or seizing them, thereby interfering with the operation of the project (so-called defensive function of the security interest) and ensuring step-in. Accordingly, it is common for the lender to pledge a security interest on all significant assets belonging to the project (i.e., the principle of total asset mortgage). Specifically, the following security interests may be established for the following assets.³

Assets	Security Interests	Perfection
Shares of operator	Share Pledge	Enrollment or record onto the stockholder register
Equity interest as an employees of operator	Pledges of Claims	Notice with fixed date stamping to the Borrower or consent with fixed date stamping of the Borrower
<i>Tokumei-Kumiai</i> investment Interest in operator	Pledges of Claims	Notice with fixed date stamping to the Borrower or consent with fixed date stamping of the Borrower
Account receivable for credits and off-takers related to major project-related contracts	Pledges of Claims	Notice with fixed date stamping to the other party to the project-related contract or consent with fixed date stamping of the other party to the project-related contract

² In recent years, many project finance projects related to renewable energy power generation projects are generally provided project finance loan during the construction period.

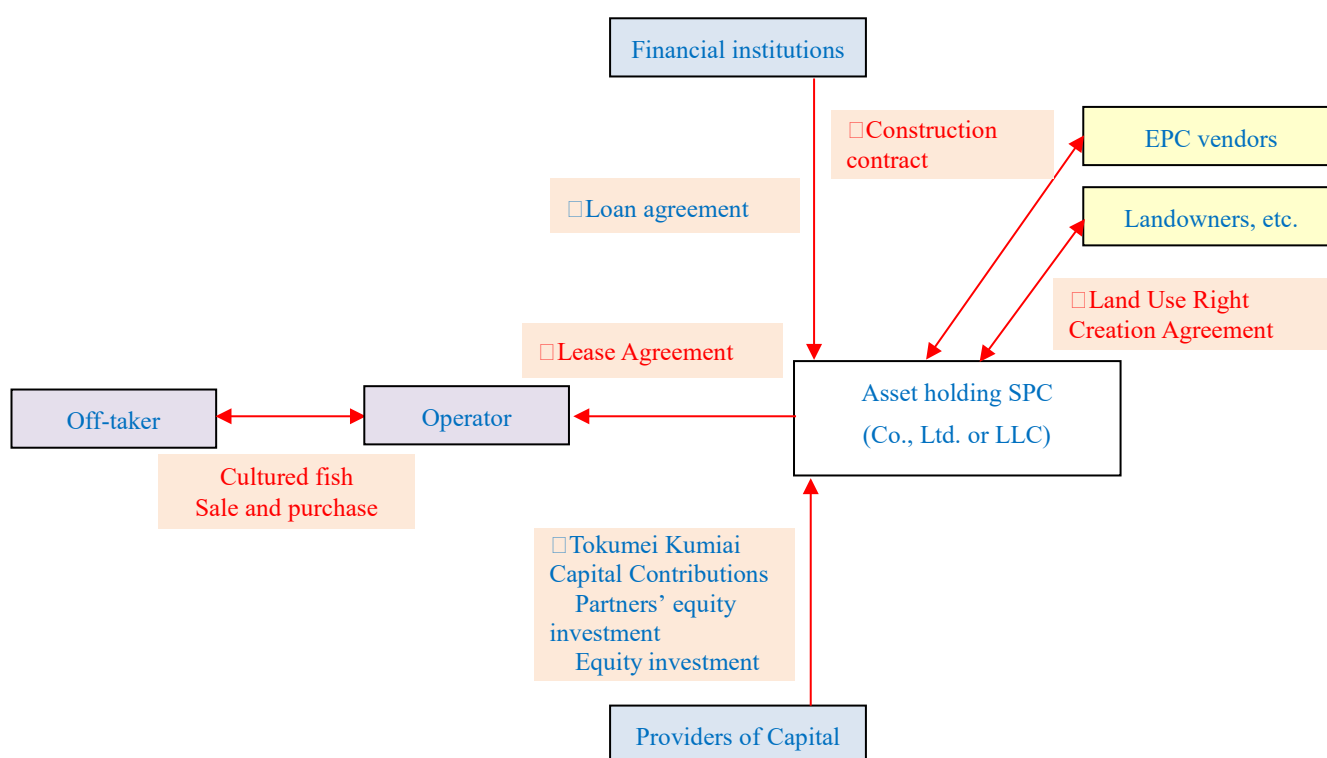
³ Real estate (aquaculture facilities, etc.), vessels and their auxiliary facilities, and land use rights related to aquaculture facilities may be combined to form a fisheries foundation and mortgaged (Mortgages for Fishery Foundation Act clause1 of article2).

Contractual status for major project-related agreements	Options of transfer of the contractual status ⁴	-
Real estate (aquaculture facilities, etc.)	Mortgage	Registration
Movable asset (aquaculture facilities, aquaculture fish, etc.)	Security assignment of movable asset	Construction Transfer with Retention of Possession (<i>Senyu-Kaitei</i>) or movable asset assignment registration
Land Use Right Pertaining to Aquaculture Equipment	Mortgages (in the case of superficies) / mortgages or pledges (in the case of land leases rights)	Registration (in the case of superficies) / Registration (in the case of land lease rights)
Insurance Claims	Pledges of Claims	Notice with fixed date stamping to the insurer or consent with fixed date stamping of the insurer
Deposit receivables	Pledges of Claims	Notice with fixed date stamping to the bank with which the account is opened or consent with fixed date stamping of the bank with which the account is opened

4. Assumed Structure for Asset Holder Financing

(1) Structure overview

The structure as a project finance for asset holders can be as follows.



- (i) A special purpose company (generally a joint-stock company or limited liability company) will be established as an asset holder, and equity investors will invest in the asset holder.
- (ii) The lender makes a project finance loan to the asset holder.

⁴ Options of contractual status transfer are established for step-in purposes; it is not strictly a security interest and it is not considered possible to completed the perfection against a third party upon it. However, in practice, it is common to obtain the fixed-date consent of the other party to the project-related agreement when agreeing on the options of contractual status transfer.

- (iii) With investments from equity investors and project finance loans from lenders as sources, the asset holder enters into agreements for the establishment of rights to use the leased land for aquaculture equipment, agreements for the construction of aquaculture equipment, and other agreements required for the construction of aquaculture equipment, and accordingly takes ownership of the aquaculture equipment.
- (iv) The asset holder leases the aquaculture facility to operator and operator uses the aquaculture facility to conduct the aquaculture business. Asset holders will repay project finance loans and pay dividends to equity investors using the lease payments received from operator.

This structure is very close to project financing if operator, the lessee, is a special purpose company that only engages in the target aquaculture business using the relevant aquaculture facility. However, if operator, the lessee, is a company that engages in the other business or aquaculture business using facilities other than the relevant aquaculture facility, it has a corporate finance-like character based on the creditworthiness of the lessee. In addition, although it is close to asset financing in that leases are used, if it is based on the cash flow from the aquaculture business, and finance is provided in excess of the liquidation value of the aquaculture facility, it is considered to differ from a typical lease transaction.

There are also a number of variations in the economic terms of transactions, such as if Lessee is a creditworthy operating company that also conducts other business or is sponsored by an affiliate of such an operating company, (i) fixed lease payments or set minimum lease payments to enable debt and equity investors to expect a stable return on their investment, or (ii) by making a portion of the lease payments performance-linked to the targeted aquaculture business, thereby allowing them to seek more favorable spreads while bearing the risks of the targeted aquaculture business.

(2) Security packages

As mentioned above, the financing for asset holders may vary depending on the nature of the asset holder and operator and the target on which it relies (whether limiting to liquidation value of the aquaculture facilities or including cash-flow from the project). Security packages should also be considered for each transaction. In the following, however, we will consider cases similar to project financing, where the principal of total asset mortgage is to be applied. It should be noted that a security package may need to be constructed that includes two types of security interests: (i) the lender's security interest (first ranking) in which the lender has a loan claim with respect to the asset holder as a secured claim, and (ii) the asset holder's security interest (second ranking) in which the asset holder has a lease payment claim with respect to operator as a secured claim. Specifically, the following security interests may be established for the following assets.⁵

Assets	Security Interests	Perfection
Security Interest of Lender Pertaining to Assets Held by Asset Holders, etc. (First Ranking)		
Shares related to asset holders	Share Pledge	Enrollment or record onto the stockholder register
Equity interest as an employee of Asset Holders	Pledges of Claims	Notice with fixed date stamping to the Borrower or consent with fixed date stamping of the Borrower
<i>Tokumei-Kumiai</i> investment interests in asset holders	Pledges of Claims	Notice with fixed date stamping to the Borrower or consent with fixed date stamping of the Borrower
Asset holders' claims on major project-related agreements (including lease agreements)	Pledges of Claims	Notice with fixed date stamping to the other party to the project-related contract or consent with fixed date stamping of the other party to the project-related contract

⁵ As in the case of financing for operator, real estate (aquaculture facilities, etc.), vessels and their auxiliary facilities, and land use rights related to aquaculture facilities may be combined to form a fisheries foundation and mortgaged (Mortgages for Fishery Foundation Act clause 1 of Article 2).

Contractual Status of Asset Holders for Key Project-Related Agreements (Including Leases)	Option of transfer of the contractual status	-
Real estate of asset holders (aquaculture facilities, etc.)	Mortgage	Registration
Movable asset of the asset holder (aquaculture facilities)	Security assignment of movable asset	Construction Transfer with Retention of Possession (<i>Senyu-Kaitei</i>) or movable asset assignment registration
Land Use Right Pertaining to Aquaculture Equipment	Mortgages (in the case of superficies) / mortgages or pledges (in the case of land lease rights)	Registration (in the case of superficies) / Registration (in the case of land lease rights)
Insurance Claims held by the asset holder	Pledges of Claims	Notice with fixed date stamping to the insurer or consent with fixed date stamping of the insurer
Deposit receivables held by asset holders	Pledges of Claims	Notice with fixed date stamping to the bank with which the account is opened or consent with fixed date stamping of the bank with which the account is opened
Security interest (first rank) held by the lender in relation to the assets held by operator, etc., and security interest (second rank) held by the asset holder in relation to the assets held by operator, etc.		
Shares relating to operator (where operator is a special-purpose company)	Share Pledge	Enrollment or record onto the stockholder register
Equity interest as an employee of operator (where operator is a Special-Purpose Company)	Pledges of Claims	Notice with fixed date stamping to the Borrower or consent with fixed date stamping of the Borrower
<i>Tokumei-Kumiai</i> investment Interest in operator	Pledges of Claims	Notice with fixed date stamping to the Borrower or consent with fixed date stamping of the Borrower
Operator's receivables related to major project-related contracts (including sales contracts with off-takers)	Pledges of Claims	Notice with fixed date stamping to the other party to the project-related contract or consent with fixed date stamping of the other party to the project-related contract
Contractual status of operator for major project-related contracts (including sales contracts with off-taker)	Option of transfer of the contractual status	-
Movable asset of operator (aquaculture fish, etc.)	Security assignment of movable asset	Construction Transfer with Retention of Possession (<i>Senyu-Kaitei</i>) or movable asset assignment registration
Insurance Claims held by operator	Pledges of Claims	Notice with fixed date stamping to the insurer or consent with fixed date stamping of the insurer
Deposit receivables held by operator	Pledges of Claims	Notice with fixed date stamping to the bank with which the account is opened or consent with fixed date stamping of the bank with which the account is opened



[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.