# Trends and Developments

**Contributed by:**
Hikaru Naganuma and Wataru Ishii
**Anderson Mori & Tomotsune**

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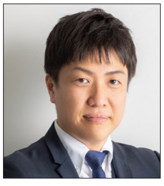
## Authors



**Hikaru Naganuma** is a partner at Anderson Mori & Tomotsune who has been engaged in an extensive range of corporate matters, with an emphasis on securitisation of real properties and receivables, project finance, syndicated loans, real estate transactions and M&A transactions. He has also assisted both domestic and overseas clients in a variety of cross-border transactions in the areas of real estate investment, banking and corporate acquisitions.

**Wataru Ishii** is a partner at Anderson Mori & Tomotsune who has been engaged in an extensive range of corporate matters, especially focusing on financial transactions including project finance, private finance initiatives, real estate finance and structured finance.

Anderson Mori & Tomotsune

Otemachi Park Building
1-1-1 Otemachi
Chiyoda-ku
Tokyo
100-8136
Japan

Tel: +81 3 6775 1214
Fax: +81 3 6775 2214
Email: hikaru.naganuma@amt-law.com
Web: www.amt-law.com/en/

## General Overview of the Residual Effects of COVID-19 on Japan

Until 2022, the COVID-19 pandemic was one of the significant concerns in the Japanese financial market. However, from 8 May 2023, the classification of COVID-19 was downgraded to that of a common infectious disease in Japan. Against this backdrop, economic activities have been returning to normal, and the Japanese financial market has been showing a robust recovery led by a growing appetite of foreign investors against the backdrop of a depreciating yen and a low interest rate environment in Japan.

## Monetary Easing Policy of the Bank of Japan

The Bank of Japan (BOJ), the central bank of Japan, has adopted a policy of dramatic monetary easing in recent years to stimulate the Japanese economy. This has continued in light of the significant disruptions to the Japanese and global economy as a result of the COVID-19 pandemic. According to the Statement of Monetary Policy published by the BOJ on 28 July 2023, the BOJ decided to continue its policy of monetary easing. As part of this policy, the following, among other measures, have been adopted:

- with respect to short-term interest rates – the application of a negative interest rate of minus 0.1% to the Policy-Rate Balances in the current accounts held by financial institutions with the BOJ; and
- with respect to long-term interest rates – the purchase by the BOJ of such amount of Japanese government bonds (JGBs) without any upper limit as is necessary for the ten-year JGB yield to remain at around 0%.

The BOJ also announced that the method of yield curve control will be conducted with an aim to keep fluctuation of long-term interest rates within a degree of approximately 0.5%, which would virtually act to allow more flexibility on increase in long-term interest rates going forward.

## Recent Trends and Developments in Financial Markets

### *Real estate finance*

*Market trend overview*

During the COVID-19 pandemic, the real estate market in Japan was adversely affected by the uncertainty surrounding tourism. In particular, some hotel properties in Japan suffered from a serious decline in cashflow due to a drop in occupancy rates and faced breaches of their financial covenants. However, there has recently been a growing interest in (commercial and residential) real estate investments in Japan, indicated by the greater demand among both domestic and foreign investors with surplus funds, who are looking beyond the pandemic curve. In fact, an increasing number of high-rise complex buildings are being constructed in urban areas including the Azabu, Yaesu and Nihonbashi areas in Tokyo, and fierce demand for development sites contributes to land prices in urban areas remaining high. Additionally, continuing demand for logistics properties and data centre facilities is expected, driven by the growth in e-commerce and cloud services.

#### *Real estate security tokens*

Security token offerings (STOs), an alternative form of fundraising under which security tokens representing certain rights are offered, has recently been in the spotlight in Japan.

In July 2021, a securities registration statement (SRS) was filed for the issuance of tokenised beneficiary interests in a trust pursuant to the Financial Instruments and Exchange Act of Japan. According to that SRS, the underlying asset of the relevant trust is a residential property in Tokyo. The tokenised beneficiary interests were underwritten by securities houses and distributed to investors. According to press releases, the offering is the first public offering of security tokens in Japan involving a trust with beneficial interest certificate backed by assets, made possible by co-operation between the relevant real estate company, trust bank and two securities houses, which came together to formulate a viable transaction structure. In 2023, security tokens have been gaining popularity as an established method for raising funds from individual investors and quite a number of financial institutions are entering into the market for this financial product.

### *Acquisition finance*

#### *Market trend overview*

In 2020, several borrowers and their group companies were severely damaged due to the COVID-19 pandemic, following which they had to request waivers of breaches of financial covenants or emergency credit from lenders. In some cases, portfolio companies, including those with some of the largest-scale leveraged financings in Japan, have been forced into bankruptcy or civil rehabilitation. Due to this development, the terms of lending (including the financial covenants required by lenders) have temporarily increased in stringency, on top of increases to interest margins by around 50–100bps as compared to rates in the pre-COVID-19 market. In 2023, however, the leveraged buyout market has been active by virtue of the strong continuing interest by both domestic and foreign private equity (PE) funds in investment opportunities in Japan. Notably, there are signs that lenders, including the Japanese “mega banks” (MUFG Bank, Sumitomo Mitsui Banking Corporation and Mizuho Bank) are now gradually returning to pre-pandemic lending terms, but they are still seeking various ways to transfer credit risk.

#### *Latest trends in leveraged buyout transactions*

In July 2020, the Ministry of Economy, Trade and Industry of Japan (METI) published a paper entitled “Practical Guidelines for Business Transformations – Toward Changes to Business Portfolios and Organisations”. This paper, intended to encourage businesses to embrace business restructuring to achieve sustainable growth, has resulted in an increasing number of divestitures by Japanese conglomerates of their assets or non-core businesses (including divestment of shares in their subsidiaries, both private and public, that operate such non-core businesses) to third parties, such as PE funds. In some of these transactions, Japanese sellers have committed to substantial reinvestments into divested businesses and continuing involvement in the management of those businesses.

It is also notable that there is a growing number of "going private" transactions effected by way of tender offer bid. Some of these transactions have been implemented by the management of target companies accepting co-investments from financial equity contributors, including PE funds.

From a financing perspective, co-investment structures of this kind present some practical hurdles, such as how certain values can be ascertained in the event of dead-lock situations. However, lenders have recently shown more flexibility when appropriate arrangements have been able to be made to secure their interests, such as ensuring that share pledges and other security interests are able to be enforced.

*Variation in mezzanine financing methods*

In Japan, multiple tranche senior loans (with both amortisation features and bullet repayment features) are the most typical method by which leveraged acquisitions are financed. Mezzanine financing is also a valid option for sponsors wishing to limit equity contribution amounts. Typically, mezzanine financing is made in the form of subordinated loans or preferred shares (whether convertible or otherwise). Recently, with more sponsors seeking higher leverage, mezzanine loans to the holding companies of borrowers in senior loans have been gaining in popularity. Such holdco mezzanine loans are structurally subordinated to the senior loans, as a result of which no intercreditor agreement is generally required between the senior lenders and the holdco mezzanine lenders.

While the structure of holdco mezzanine loans varies depending on the time at which such holdco mezzanine loans are obtained, it is often the case that no security interest over shares in the senior borrower or target group companies is created in favour of the lenders of holdco mezzanine loans, in order to avoid any conflict with security interests in favour of senior lenders. In some transactions, lenders have the right to require a borrower to dispose of its shares in the senior borrower upon the occurrence of an event of default, to the extent that the exercise of such mandatory disposal right does not conflict with the interest of the senior lenders.

***Project finance***

*Market trend overview*

The impact of the COVID-19 pandemic on the financing of renewable energy projects has been limited, compared to other types of financing. This is mainly because the pandemic has not had an adverse effect on electricity prices under the Feed-in Tariff system in Japan.

*Promotion of offshore wind power projects*

The Japanese government intends to expand domestic electricity supply from offshore wind power-generation facilities. According to the Vision for Offshore Wind Power Industry (1st) published on 15 December 2020, the Japanese government set the following targets for the enhancement of the offshore wind power industry:

- the development of offshore wind power projects of 10 million kW or more by 2030; and
- the development of offshore wind power projects, including floating offshore wind power

projects, of between 30 million kW and 45 million kW, by 2040.

To promote offshore wind power projects, the Act on Promoting Utilisation of Sea Areas for the Development of Marine Renewable Energy Generation Facilities of Japan (the "Marine Renewable Energy Act") came into effect on 1 April 2019. Under the Marine Renewable Energy Act, the Minister of Economy, Trade and Industry and the Minister of Land, Infrastructure, Transport and Tourism designate certain sea areas that conform to certain criteria as promotion zones for the development of marine renewable energy generation facilities (each a "Promotion Zone") and a business operator who will develop and operate offshore wind power-generation facilities in a Promotion Zone is designated through a public tender process.

As of 31 July 2023, business operators have been designated for each of the following Promotion Zones:

- the sea area off the shore of Noshiro City, Mitane Town and Oga City, Akita Prefecture;
- the sea area off the shore of Yurihonjo City, Akita Prefecture (northern side);
- the sea area off the shore of Yurihonjo City, Akita Prefecture (southern side);
- the sea area off the shore of Choshi City, Chiba Prefecture; and
- the sea area off the shore of Goto City, Nagasaki Prefecture.

In addition, public tender processes for the following Promotion Zones are being carried out and the business operators for each of those Promotion Zones will soon be designated:

- the sea area off the shore of Happo Town and Noshiro City, Akita Prefecture;
- the sea area off the shore of Oga City, Katagami City and Akita City, Akita Prefecture;
- the sea area off the shore of Murakami City and Tainai City, Niigata Prefecture; and
- the sea area off the shore of Ejima, Saikai City, Nagasaki Prefecture.

The amount of project financing for offshore wind power projects is expected to increase as the Japanese government continues to encourage the development and expansion of the offshore wind power business and projects in Japan.

*Solar power projects*

The development of large-scale solar power projects may become less attractive to investors because of the reduction of the expected sales price of electricity applicable to recently certified projects. However, the purchase and sale of already developed solar power projects with favourable Feed-in Tariff conditions are active.

One of the recent topics regarding solar power projects is the introduction of decommissioning reserves. A solar power project of 10kW or more is required to reserve the costs of decommissioning of solar power plants in the last ten years of the Feed-in Tariff or Feed-in Premium period applicable to the project. Calculation of the amount to be reserved is based on the designated amount per kWh. Although the reserve amounts are maintained by the Organisation for Cross-regional Co-ordination of Transmission Operators, Japan, in principle, internal reserves are allowed if certain requirements are met.

*Other renewable power projects*

Project finance transactions for other renewable power projects have also been active. One of the examples is a project finance transaction for a geothermal power project in Kumamoto Prefecture in June 2021, which was publicly announced by the arranger bank. Although there would be possible risks peculiar to geothermal power projects such as:

- uncertainty of the amount of resources under a project site;
- limitations on the examination and development of a project site which is in an area designated as a national park or a quasi-national park; and
- acquisition and possession of rights to dig a project site to use hot water and steam that spring up from the ground, in co-ordination with local persons, such as those who operate and manage a hotel with hot springs,

it is expected that subsequent project finance transactions for geothermal power projects will be arranged in the near future.

*Introduction of the Feed-in Premium Scheme*

The Feed-in Premium scheme was introduced in April 2022, in addition to the existing Feed-in Tariff scheme. Under the Feed-in Premium scheme, revenue from renewable power projects consists of:

- revenue from transactions at the electricity exchange or pursuant to bilateral agreement; and
- premiums calculated in accordance with certain formulae.

The Minister of Economy, Trade and Industry designates the type of power sources to which the Feed-in Premium scheme is applicable.

***ESG finance***

ESG finance has been getting more attention from participants in the Japanese finance market.

For example, according to the Ministry of the Environment Government of Japan (MOE), the number of green loan deals has increased from one in 2017 to 180 in 2022. The Japanese government encourages expansion of ESG finance transactions by, for instance, issuing MOE guidelines for green loans, green bonds, sustainability-linked loans and sustainability-linked bonds. So far, the impact of ESG-related issues on the terms and conditions of acquisition finance documentation in Japan has been limited, but this is expected to change as ESG concerns grow in significance.