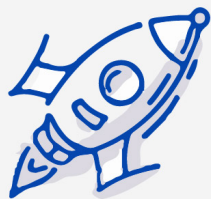


ANNEX:

Empathy driven funding



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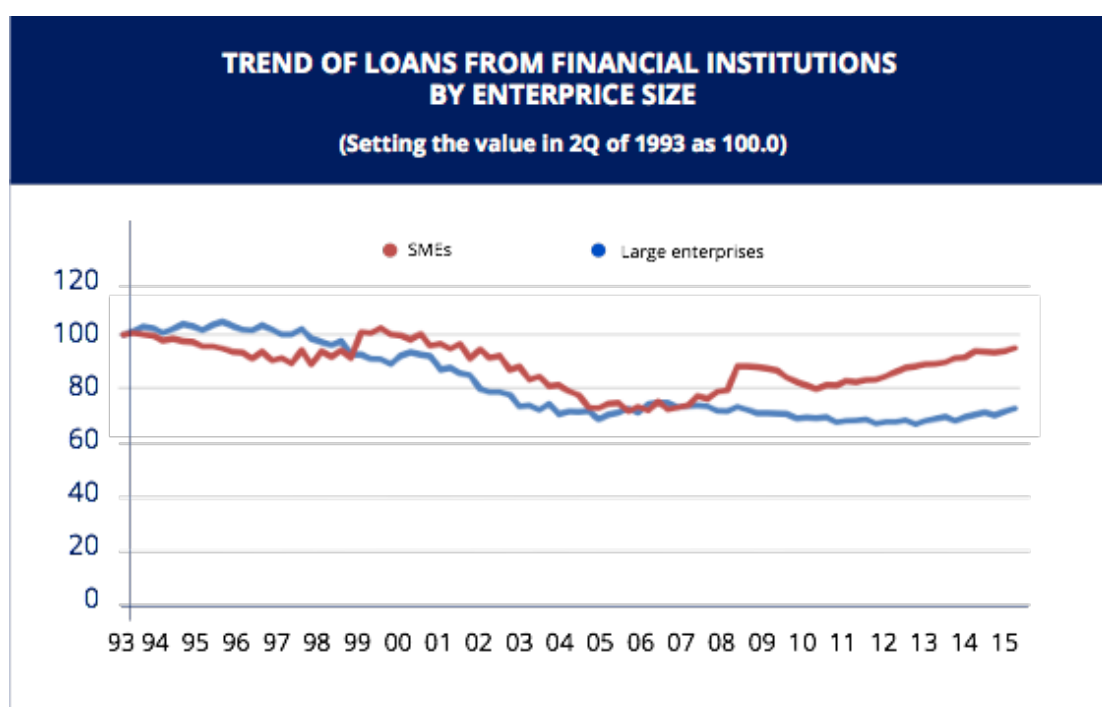
Background

➤ 1.1 Background

Insufficient financing to MSMEs as regional financial institutions.

In practice, most of MSME's capital relies on bank loans especially in local areas in Japan. After the collapse of the economic bubble in 1992, the amount of bank loans to large enterprises and MSMEs significantly decreased by approx. 30%. The trend of bank loan differs thereafter by the scale of the enterprise. While the level of lending to large enterprises has recovered to levels of the early 1990s (amidst some fluctuations) up to 2015, those of MSMEs has shown almost a constant decline.

FIGURE 1 TREND OF LOANS FROM FINANCIAL INSTITUTIONS BY ENTERPRISE SIZE



(Source: SME white paper 2016)

Main reasons for the sluggishness of bank loans to MSMEs are that the local financial institutions became cautious in lending money due to the shrinking scale of the local economies and limited labor supply according to depopulation, especially outside of the metropolitan areas where MSMEs concentrate. Particularly, there are limited financial options for the financial demands of start-ups and recovery from disasters which are considered as high-risks, and as most of MSMEs have a limited track record of bank transactions and collaterals they cannot obtain bank loans. As a result, start-ups and MSMEs have to depend on nonbank financing or bill discount which is relatively costly, and have no

affordable financial channel to expand their business or renew facilities and machines with higher technology.

➤ 1.2 Overview of New Financing Mechanism – Micro-Investment Crowdfunding

Categories of Crowdfunding

Currently, Crowdfunding can be classified into five categories depending on the compensation; donation-based, pre-purchase (reward-based), debt-based, fund type and equity-based. Micro Investment Crowdfunding falls into the fund type. Each type of crowdfunding can be summarized as in the table below.

TABLE 1 TYPES OF CROWDFUNDING

TYPE		MAIN RETURN (FINANCIAL/ NON-FINANCIAL)	RELEVANT REGULATING LAWS IN JAPAN	MAIN FUND RECIPIENT
DONATION-BASED		None (tax reduction)	Tax law (Fundraisers may be subject to capital transfer tax)	Disaster-affected area, developing countries, research expense, etc. (over 10,000 yen below 1 million yen)
PRE-PURCHASE (REWARD-BASED)		Products and services	Commercial Code (defect liability, etc.)	In addition to the above, music, movies, etc. (over 100,000 to several million yen)
INVESTMENT	DEBT BASED	Interest and principal	Moneylending Control Act and Type II Financial Instruments Business Act	Support for real estate purchase, micro-finance, etc. (several million yen to several tens of million yen)
	FUND TYPE	Dividend and services or products	Financial Instruments and Exchange Act (type II)	
	EQUITY BASED	Share (dividend)	Financial Instruments and Exchange Act (Type I and special Type I)	

The money raised on Micro Investment Crowdfunding platform is regarded as debt' on the B/S of the MSMEs. If the fund meets certain conditions required by

the Financial Services Agency (herein after referred as “FSA”), the money can be regarded as the ‘equity capital’ by financial institutions at the same time, under an anonymous partnership agreement as described in Chapter 2.

On the Financial Inspections Manual issued by FSA, it is described as “borrowings with sufficient nature as capital” under the following conditions; “they do not require redemption for long-term (5 years or longer)”, “loan interest is set in accordance with profits that the borrower makes” and “being subordinated in legal bankruptcy”. The portion of debts that deemed as capital increases 20% every year when the average life until redemption is more than 5 years, therefore, the debt ratio can be decreased every year at evaluations of financial institutions.

TABLE 2 AVERAGE LIFE UNTIL REDEMPTION

AVERAGE LIFE	PORTION DEEMED AS CAPITAL	PORTION DEEMED AS DEBT
5 YEARS OR MORE	100%	—
4 YEARS/ 5 YEARS	80%	20%
3 YEARS/ 4 YEARS	60%	40%
2 YEARS/ 3 YEARS	40%	60%
1 YEARS/ 2 YEARS	20%	80%
1 YEAR	—	100%

In any case, Crowdfunding opportunities facilitate MSMEs to obtain loans from financial institutions thanks to upgraded credit rating related to capital growth and open a wider access to financing. For example, a Japanese sake (rice liquor) brewery in the northeast region of Japan accessed Micro Investment Crowdfunding platform to obtain long-term and large sum funds for mid-term business deployment, even though the brewery’s financial needs were satisfied. The brewery’s main financing bank also saw the new equity capital as positive, from the point of strengthening their financial soundness. (This bank also has a collaborative agreement with the platform operator.)

As funds under an anonymous partnership agreement have more nature like equity capital rather than debt capital, MSMEs can advantageously access this financial product in financially troublesome times, because there is no obligation as in debt to repay original principal every month with interest. In this way, MSMEs can utilize crowdfunding to complement its funds in accordance with its business scale and performance.

As the funds are not shareholders’ equity, no other third parties except existing shareholders can intervene the business operation and thus they cannot have

any impact on other shareholder voting rights. In this regard, the fund money raised on Micro Investment Crowdfunding has a benefit for the MSMEs that do not prefer any intervention by investors in business management.

Characteristics of Raised Funds (financial cost)

The Micro Investment Crowdfunding platform is responsible for various services including advertising, contract arrangement, audit, responding, payment of financial returns and other necessary works for fund operation. On the other hand, small businesses must bear the financial cost for offering and managing the fund. Specifically, the initial arrangement fee to be paid to the platform includes costs for the fundraising webpage which are unique to crowdfunding, business due diligence, fund design for the contract, and preparation of contract materials. After fundraising and during the fund operation, the small businesses must assume the following costs will be billed. The costs for; audit management, supporting the investors relationships and preparation of reports, audit the use of fund and business sales, preparation of documents required, such as detailed statement of financial return, and office expence.

When the fund terminates, the platform charges success-fee and offers business development support such as marketing assistance, through the collaboration with investors. Some costs are fixed but most of them are vary according to the fund design. MS as an example, the below tables show the detailed costs for fundraising on Micro Investment Crowdfunding.

TABLE 3 FINANCIAL COST SIMULATION FOR MICRO INVESTMENT CROWDFUNDING (6 CASES)
<Pre-conditions>

COSTS	AMOUNT (FORMULA)
INITIAL ARRANGEMENT FEE	900,000 JPY (7,826 USD)
OPERATION FEE	2% per annum
AUDIT FEE	First year 150, 000 (1034 USD), from second year 100,000 (869 USD)
DIVIDEND	Up to breakeven point: 2% of sales/ 175 (no return payment when profit is below zero) After breakeven point: 1% of sales/175 (no return payment when profit is below zero) *105.9% when based on project plan

<Results of Simulation>

AMOUNT OF FUND			SALES TURNOVER (ANNUAL)		FINANCIAL COST (PER ANNUM) (TOTAL COST/ AMOUNT OF FUND) ÷ DURATION (2 YEAR)
CASE 1	Small	3,500,000	Low (below the breakeven point)	80,000,000	14%
CASE 2	Small	3,500,000	Middle (on the breakeven point)	87,000,000	18%
CASE 3	Small	3,500,000	High (Above the breakeven point)	110,000,000	25%
CASE 4	Large	35,000,000	Low (below the breakeven point)	800,000,000	-1%
CASE 5	Large	35,000,000	Middle (on the breakeven point)	875,000,000	4%
CASE 6	Large	35,000,000	High (Above the breakeven point)	1,100,000,000	10%

(Created by author)

According to the cases 1,2 and 3 above, the ratio of financial cost per year is higher if the amount of fund is smaller (see Case 1 to 3), or if the sales turnover is higher than the forecast (see Case 3).

The ratio of financial cost per year can be lower if the amount of fund is larger (see Case 4 to 6). The case with the lowest cost is Case 4.

This simulation shows that the ratio of financial cost for Micro Investment Crowdfunding varies considerably depending on the amount of fund and sales turnover.

More than Conventional Financing to Small Businesses

➤ 2.1 The Role of Micro Investment Crowdfunding Platform Operators

There are three important roles that a Micro Investment Crowdfunding platform operator plays; (1) Connecting the small businesses and individual investors to enhance business opportunities, (2) Providing appropriate information with legitimacy, transparency, etc. (3) Adjusting the relations among stakeholders.

① **Connecting the small businesses and individual investors to enhance business opportunities.**

As Micro Investment Crowdfunding is based on an anonymous partnership agreement which is a direct agreement between small businesses and investors, the small businesses need to promote themselves with sufficient information for the investors to make an investment decision. The provision of information through the Internet is vital in effectively promoting their business for small businesses, and effectively finding investment opportunities for the investors. Most of the connections between the small businesses and investors are done through the online platform. The online platform helps the small businesses to reach a wider range of interested individual investors, and helps the investors choose from a wider range of legitimate businesses to invest in.

Individual investors must be registered themselves to be a member of the platform website to invest in the small businesses' projects on the platforms. After due process (described in (2) below), both sides conclude an anonymous partnership agreement online. In practice, there is no legal relationship between the platform operator and individual investors.

② **Providing appropriate information with legitimacy, transparency, etc. The fund's design including the target fund amount, conditions of financial and non-financial returns are key for the success of the fund. The platform operator shall create an achievable target amount, always monitor the progress of business plan to see if the use of funds is appropriate, and the information collected by auditing is shared with investors.**

In the process of analyzing proposed business plans, their feasibility and probability are generally examined. Without past result in hand, the feasibility is carefully assessed on the assumption with similar cases of candidates. The sales are usually forecasted with several scenarios including the best and worst cases. The relevance of cash flow forecast is also studied in detail in order to provide stable financial returns.

While the financial institutions assess business potential with the profit level, the Micro Investment Crowdfunding platform operators design the

fund by putting a benchmark on the presumption of sales turnover on their assessment.

Generally, it is very difficult to analyze a probability of anticipated sales amount, but the platforms tap into interviews with business partners and objective information on internet as well as qualitative assessment.

3 Adjusting the relations among stakeholders. Finally, a crowdfunding platform operator also acts as a coordinator between various stakeholders. Collaboration with stakeholders is crucial for the platform operators especially with the small businesses who are in the rural areas with limited access to information.

As described in (1) above, the platform connects businesses and investors. In some cases, the platform connects small businesses to designers, marketing experts, and other service providers to help them develop their business appeal.

In other cases, the platform also coordinates with local governments, who wish to provide better access to finance for their local businesses, in order to revive the local economy. At present, the platform, MS, has concluded agreements with around 10 local governments and 4 Chambers of Commerce and Industry / Commerce and Industry Associations (according to the MS's presentation material in June 2016) This number is expected to have increased to around 20 by the end of FY2016.

➤ 2.2 Credit assessment by Platform Operators

☑ Roles of Financial Institutions for Direct and Indirect Financing

As the anonymous partnership agreement is regarded as a “deemed securities”, only the companies with Type II Financial Instruments Business are authorized to carry out the transactions as an intermediary. As the Micro Investment Crowdfunding is categorized as direct financing, its role is different from those of financial institutions that deal with conventional loans.

In direct financing, financial institutions take risk in lending the money that they receive from investors. On the other hand, in Micro Investment Crowdfunding, as the financial resource is directly funded by investors in the form of MSME financing as stocks and bonds, individual investors take their own risk of their investment in direct financing.

☑ Competitive and Complimentary Relationship with other Financial Products in MSME financing Market

The fundraising scheme for each stage of MSMEs, ventures, etc. is shown below based on the growth stages of businesses.

TABLE 4 GROWTH STAGES AND FINANCIAL NEEDS OF MSMES

GROWTH STAGE	SEED	EARLY	EXPANSION	LATER
SCALE OF FUNDING NEEDS	Small	Medium	Large	Large
BUSINESS RISK	High	High	Middle	Middle to low
ACTIVITIES	Basic research Applied research	Pilot project	Commercialization Mass production	Enhancing business operation
VOLUME OF SALE	None	Small	Small --> Medium	Medium --> Large
FUNDRAISING	Paid-in capital	Subsidy Angel investor VC	VC Bank loan	Medium --> Large
NEEDS FOR EQUITY- CAPITAL	Low	High	High	Middle
CROWDFUNDING'S FITNESS FOR FUNDING NEEDS	Medium Small amount of funding needs existis but the business risk is so high that financial institutions can't provide finance.	Medium Still business risk is high but micro investment crowdfunding can fit for financial needs as financial institutions hesitate to provide finance due to high business risk	High Large amount of funding is necessary but there is no assets for pledging collateral. Micro Investment crowdfunding can fit for funding needs.	Medium Still funding need is very high and micro investment crowdfunding can be an option for fundraising.

(Created by author)

Small-scale businesses at seed stage and early stage may be suitable to raise funds through Micro Investment Crowdfunding, especially when they have difficulties in obtaining a bank loan.

Financial institutions generally do not take high credit risks and are not fit for the limited and small financial needs of the small businesses. As investors of VC expect high financial returns in a short period, high-risk and high-return investment decisions are made, which are not what small businesses in our empathy-driven model can offer. As for the Micro Investment Crowdfunding platforms, they have to control the impairment risk of principal to a certain level for its business expansion and dissemination, it may be said as a middle-risk and middle-return investment which put its basis on the empathy and support from individual investors.

Companies at expansion stage over time after its start-up have an active need for financing and require a large amount of finance like IPO. The companies in that stage have overcome a phase so called "Death Valley", and their business risk is reduced compared to the VCs.

Micro Investment Crowdfunding can also be an alternative fundraising measure for companies at a later stage of growth and bridge them to a stable level which enables to obtain the bank loans.

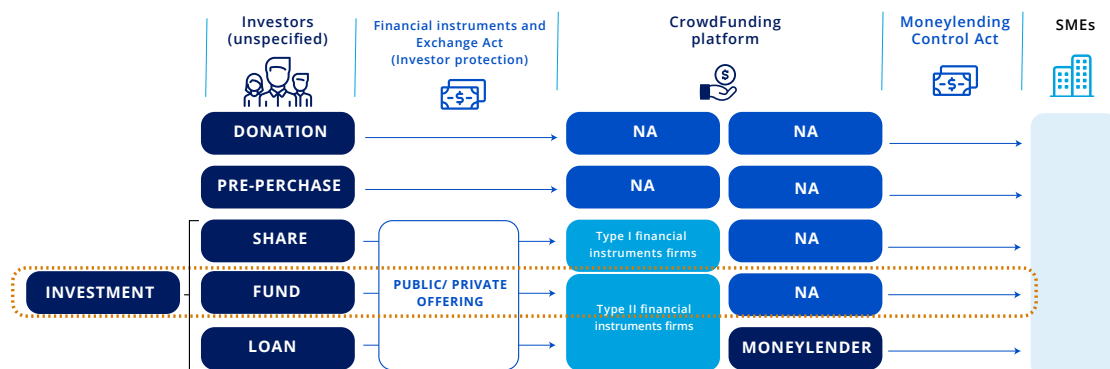
Policy Implications

3.1 Regulatory Framework of Micro Investment Crowdfunding

The framework to protect investors is developed under the Financial Instruments and Exchange Act (herein after referred as "Act"). In Micro Investment Crowdfunding, there is a possibility for the principal to be impaired. However, the individual investors who are the fund suppliers, are generally not professional investors and cannot fully assess the financial risk of investing. Thus, voluntary regulations are imposed by the Type II Financial Instruments Firms Association in addition to the Act, in order to make the transaction healthier for investors including those of Micro Investment Crowdfunding.

The Act was activated in 2006 in response to changes surrounding the financial and capital market. The Act promotes (i) thoroughly ensuring and segmenting protection rules for the investors along with their capabilities, (ii) improving their convenience, (iii) securing the market functions toward "investment from savings", and (iv) responding to the globalization of the financial and capital market¹. Financial instrument business can only be operated by those who obtained the registration by the Prime Minister (Financial Services Agency Commissioner).

FIGURE 2 FIGURE REGULATION IMAGE OF CROWDFUNDING



(Created by author)

¹The purpose of this Act is by i) developing the system for disclosure of corporate affairs and other related matters, ii) providing for necessary matters relating to persons who engage in Financial Instruments Business and iii) securing appropriate operation of Financial Instruments Exchanges, to iv) ensure fairness in issuance of the Securities and transactions of Financial Instruments, etc. and v) to facilitate the smooth distribution of Securities, as well as to vi) aim at fair price formation of Financial Instruments, etc. through the full utilization of functions of the capital market, thereby contributing to the sound development of the national economy and protection of investors. (Financial Instruments and Exchange Act Article 1)

➤ 3.2 Legal revisions and voluntary regulations over the Micro Investment Crowdfunding of recent years in Japan

- ✓ “Law to partly revise a part of the Financial Instruments and Exchange Act” (announced on May 23rd, issued on May 30, 2014)² (an excerpt)

TABLE 5 LAW TO REVISE THE FINANCIAL INSTRUMENTS AND EXCHANGE ACT

PROMOTING THE USE OF MICRO INVESTMENT CROWDFUNDING	
<p>1</p> <p>RELAXATION OF ENTRY REQUIREMENTS</p>	<p>(Before revision) All intermediaries have to be registered as a financial instrument business firm for soliciting the securities.</p> <p>(After revision) For the intermediaries that deal a small amount of fund, the minimum capital standard amount which is required at the registration is reduced.</p> <p>New</p> <ul style="list-style-type: none"> ✓ Online application-type offering business is newly established. This business has to be as follows; offering of private equities (Type I), deemed securities (Type II) is handled as private offering and the businesses that handle below 100 million yen [USD 869,565] of the total issuance amount of the equities, with the investment amount below 500,000 yen [USD 4,347] per investor.
<p>2</p> <p>DEVELOPMENT OF RULES FOR PROTECTING INVESTORS</p>	<p>(Development of the rules)</p> <ul style="list-style-type: none"> ✓ Crowdfunding platforms are required to provide information and will be checked along with the regulations to eliminate fraudulent acts in soliciting investment products on the Internet.
REVISION OF REGULATIONS FOR THE FUND DISTRIBUTORS (PLATFORM OPERATORS)	
<p>1</p> <p>DEVELOPMENT OF RULES FOR THE FUND DISTRIBUTORS</p>	<p>(Before revision) Type II financial instruments firms are prohibited from soliciting investment in funds of which separate management is not secured in the fund terms. (Occurrence of diversion without separate management)</p> <p>(After revision)</p> <ul style="list-style-type: none"> ✓ In addition to the above, the act of solicitation by Type II financial instruments firms with knowledge that the money invested in funds is spent for other purposes is added to prohibited matters.
<p>2</p> <p>ESTABLISHMENT OF AN OFFICE IN JAPAN (MANDATORY)</p>	<p>Type II financial instruments firms are required to establish an office in Japan and allocate a person in charge of that office as the same rule as the securities firms.</p>

²Source: Financial Services Agency: <http://www.fsa.go.jp/common/diet/186/01/setsume.pdf>

<Impacts of the above partial revision>

This revision is the first development of crowdfunding-related laws aiming to increase Micro Investment Crowdfunding platforms and vitalize the transactions by easing the requirements. At the same time, it also develops the regulations and strengthen management of platforms to protect the investors. The minimum market rules for the Micro Investment Crowdfunding were developed by this revision.

- ④ Voluntary regulations (Type II Financial Instruments business Firms Association).

TABLE 6 SUMMARY OF VOLUNTARY REGULATIONS

①	Fund amount of Micro Investment Crowdfunding should be below 100 million yen [USD 869,565] per year/MSME.
②	Soliciting those deemed securities through home visit and/or phone is prohibited.
③	Fund money must be managed separately from MSME's own assets.
④	Providing necessary information for individual investors. Following information must be offered to individual investors after the completion of each fiscal year under an anonymous partnership agreement (in practice, it is offered on the exclusive website): 4.1 Overview of target business, use of funds, and actual sales 4.2 Amount of financial returns and its amount per share.
⑤	Confirmation of sales accounts and payment of the financial returns must be confirmed by accountants or tax accounts.

<Impacts of above voluntary regulations>

Along with the revision of the Financial Instruments and Exchange Act, guidelines for Micro Investment Crowdfunding are provided by these voluntary regulations. Through them, basic instructions and advisories to comply the revisions above were developed in order to ensure the investor protection as well as cultivate the use of this new financial instrument, Micro Investment Crowdfunding.

Challenges to use new financing mechanism/Micro Investment crowdfunding in LAC region

➤ 4.1 Issues for promoting the use of Micro Investment Crowdfunding in Japan

☑ Expand the number of a huge variety of private investors

Private investors of **Micro Investment Crowdfunding** are registered as the member of each Micro Investment Crowdfunding platform. It is necessary to increase the number of those members to expand fundraising and satisfy the needs of small businesses.

One of the platform, MS is working to increase the members by collaborating with other companies which have a wide network of members such as a credit card company and mileage club of airlines.

Another issue is how to tap into the senior generations who are not experienced Internet-users, but usually with relatively huge personal assets. In addition, it is necessary to attract those potential individual investors while keeping the existing members by keeping a certain amount of the financial returns (at least around the same amount of principal) with attractive non-financial returns and create a cycle of reinvestment with that invested money.

☑ Reduce costs for fundraising on Micro Investment Crowdfunding platform

Due diligence fees account for a large portion of the whole costs for the fundraising on the Micro Investment Crowdfunding. While personnel and administrative costs are required for the appropriate assessment of small businesses across Japan, they tend to consider these costs are quite high. However, the value of the **Micro Investment Crowdfunding** is that offering an opportunity to raise fund from individual investors without a collateral or guarantee, so many small businesses need to consider if the cost is appreciate according to its value. It means that there remains much room for dissemination of Micro Investment Crowdfunding scheme.

At the same time, the fees can be reduced by developing more profitable business model for the platforms through the improvement and standardization of internal processes and operating system, such as organizing manuals and training to asses "empathy", outsourcing an

accounting section to the local certified accountants or tax accountants, and utilizing Fin-Tech technologies (assessment, web meetings etc.).

④ **Clarification of risk tolerance of Micro Investment Crowdfunding**

Micro Investment Crowdfunding is driven by personal empathy and expectations for the revitalization of local economies rather than financial return. Financial returns are set by each case based on the assessment of the company's creditworthiness and business potential. Although Micro Investment Crowdfunding has a possibility for the principal to be impaired and platform operators try to prevent it, the risk is not quantified or controlled.

The assessment for the risk is based on the accumulated experience of Micro Investment Crowdfunding platforms where the decision is made subjectively based on the **project's empathy**. As it is a financial product which the principal is not guaranteed, platforms need to control and clarify the level of risk for the principal impaired, and this risk tolerance is key for increasing the number of investors. The risk tolerance generally differs by asset scale and cash flow of investors. However, platforms need to analyze the balance between the risk tolerance of investors and the size of their empathy. As far as this risk exists, platforms need to provide individual investors more information for making a decision so that to increase their sense of security.

Behind an empathy driven financing is a decision made not only based on profitability, but a strong sense of unity and helping others, which is an inherent part of Japanese culture. Even though the principal is not guaranteed, many small businesses recognize that they need to generate a certain amount of financial returns, at least more than the principal to satisfy the investors and complete their tasks on the project. Each of them try their best to be a "good fund" and to be trusted. This mentality, it can be said, is rooted in Japanese culture, and is a pillar that drives the success of the Micro Investment Crowdfunding mechanism in Japan.

➤ **4.2 Improvement of the environment surrounding the Micro Investment Crowdfunding**

④ **Effectively find the good businesses**

As empathy driver differs to each individual, whether individual investors repeatedly use Micro Investment Crowdfunding or not depends on the overall returns which include a sense of satisfaction related to social significance, promoting local economy etc. If the platforms can offer attractive and satisfactory funds, individual investors will have a greater trust and invest repeatedly. Platform operators always need to maintain a wide but good selection of investment projects that match the needs of

member investors. Platform operators need to discover those “good” small businesses for their efficient management, not only based on their accumulated experience, but also to assess the small businesses under some defined criteria.

✓ **Simplify the taxation and accounting**

Investing through Micro Investment Crowdfunding is not covered by the securities taxation system. The investment results cannot be aggregated like other financial products and are not tax-deductible in Japan. The Funds to support disaster-affected areas are also not eligible for tax deduction of special donations.

The income from Micro Investment Crowdfunding is categorized as “other income” and subject to a 20.42% tax in the current taxation system. “Other income” needs to be reported at the income tax return, and losses on these investments cannot be offset against the tax liabilities.

Funds for disaster affected areas—50% of the investment is treated as a donation and the remaining 50% is also treated as an investment—are out of scope for deduction of special donation and NISA³, and the securities taxation system is not applicable. According to the actual taxation rules, individual investors cannot benefit from any tax advantages. If such tax benefits are applied as same as other investment products, the funds of Micro Investment Crowdfunding become more attractive.

In addition, Micro Investment Crowdfunding funds are not allowed to be withdrawn or sold under the anonymous partnership agreement. These circumstances may discourage some individual investors to make a Micro Investment Crowdfunding with long period of maturity. In conclusion, there is ample room to promote this innovative financial instrument.

³ Small investment tax exemption system which is similar to British “ISA”(Individual Saving Account).

Reference1: Example Case of Other Innovative finance in Japan

A case study of Funding Project (investment fund launched by a local credit union in Gifu Prefecture)

A local financial institution created an investment fund which aims to channel financial support to the local entrepreneurs with a high growth potential and provides seed/growth capital in the H City and T City region (herein after referred to as the “H-T region”), Gifu Prefecture. The fund was originally financed by a local financial institution (credit union) and doesn't target an IPO; its objectives are to support the local MSMEs and the regional economic development.

R1- 1 OVERVIEW OF T CITY AND H CITY⁴

FIGURE 3 STRUCTURE OF THE H-T YUI FUND LIMITED PARTNERSHIP FOR INVESTMENT



	T CITY	H CITY
POPULATION (ESTIMATION AS OF OCT 1, 2016)	88,381	24,274
AREA	2,177.61km ²	792.53km ²
FOREST COVERAGE RATE	92%	92%
INDUSTRIAL PROPORTION (2013)	Primary sector: 3.5% Secondary sector: 20.1% Tertiary sector: 75.6%	Primary sector: 2.3% Secondary sector: 43.3% Tertiary sector: 53.5%
NUMBER OF COMPANIES (2014)	6,600	1,468

⁴ City Guide of H City http://www.city.hida.gifu.jp/b_sougou/w_profile/w_shiseiyouran/data/shiseiyouran.pdf (viewed on Nov. 17, 2016)

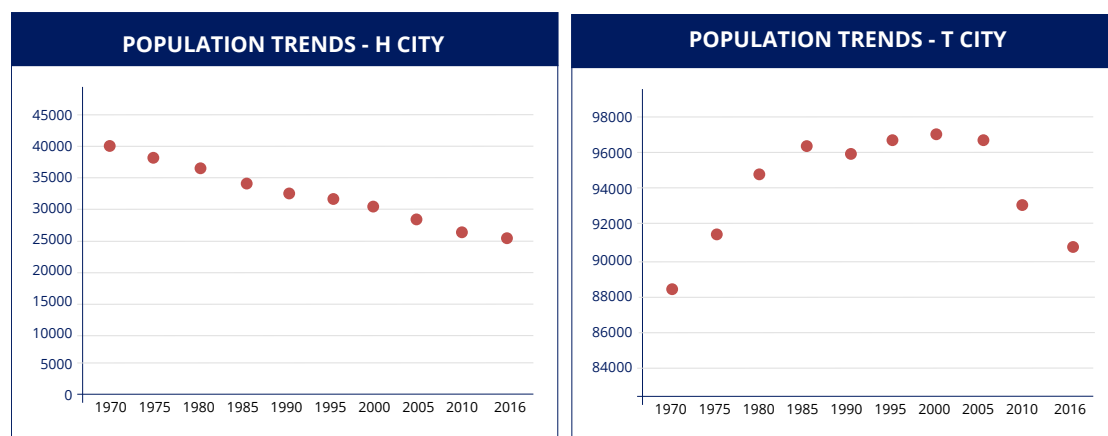
T City is a municipal city in the northern east part of Gifu Prefecture, with a population of 88,381. It became the largest city in Japan according to the integration with other municipalities in 2005 (almost as large as Tokyo Metropolis). The city is blessed with abundant nature, enjoying a forest coverage of 92%.

H City is adjacent to T City, a municipal city with a population of 24,274. It is located on the northern side of the Mountain Range, with a 92% forest coverage. H City has an aging population, with an elderly share of 36.19% (as of 2015.)

The two cities form the so-called H-T region, surrounded by the Northern Alps and the H Mountains, reaching over 3,000 m high. This region has a rich nature, exposed to the Japan Sea-side climate with an annual average temperature of 11°C, but snows heavily in winter while it becomes over 30°C in summer. In rhythm with the four seasons, a diversity of climate established an appealing touristic culture throughout a year. In recent years, the population has been aging and decreasing in both cities, the same as in other local cities in Japan.

The two cities form the so-called H-T region, surrounded by the Northern Alps and the H Mountains, reaching over 3,000 m high. This region has a rich nature, exposed to the Japan Sea-side climate with an annual average temperature of 11°C, but snows heavily in winter while it becomes over 30°C in summer. In rhythm with the four seasons, a diversity of climate established an appealing touristic culture throughout a year. In recent years, the population has been aging and decreasing in both cities, the same as in other local cities in Japan.

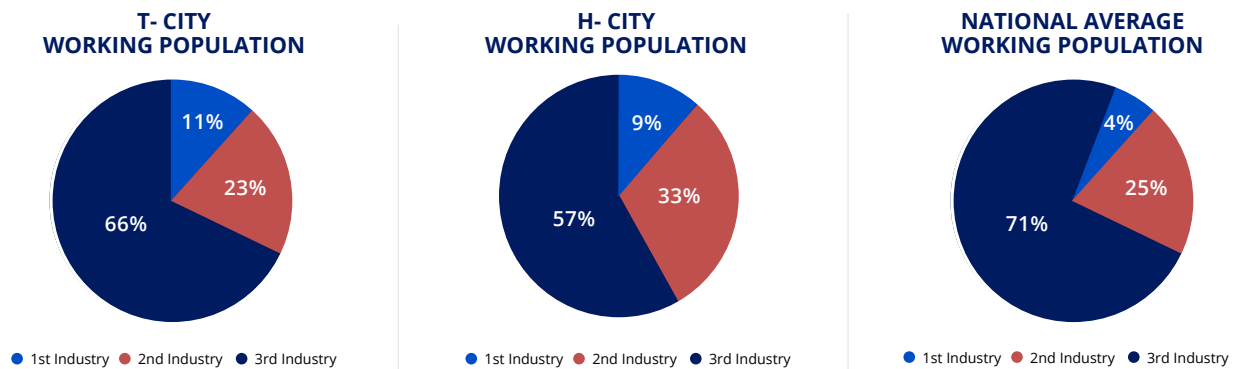
FIGURE 4 POPULATION TRENDS T CITY AND H CITY



(Source: National Census)

Regarding industries, both cities have higher ratios of primary sector workers than the national average, because of many people engaged in agriculture and forestry. T City's population is larger than H City's, and the proportion of tertiary sector is high, and the number of companies also greatly exceeds H City.

FIGURE 5 INDUSTRIAL STRUCTURES IN T CITY AND H CITY / COMPARISON WITH THE NATIONAL AVERAGE (BY WORKING POPULATION)



(Source: National Census)

H City has long thrived as a manufacturing city, which is reflected in the high percentage of secondary sector workers. There are various manufacturing companies in the city, producing Japanese sake and candles, which are well known in the domestic market, as well as non-ferrous alloys, medicinal products, car parts, ceramic products, and electronic components.

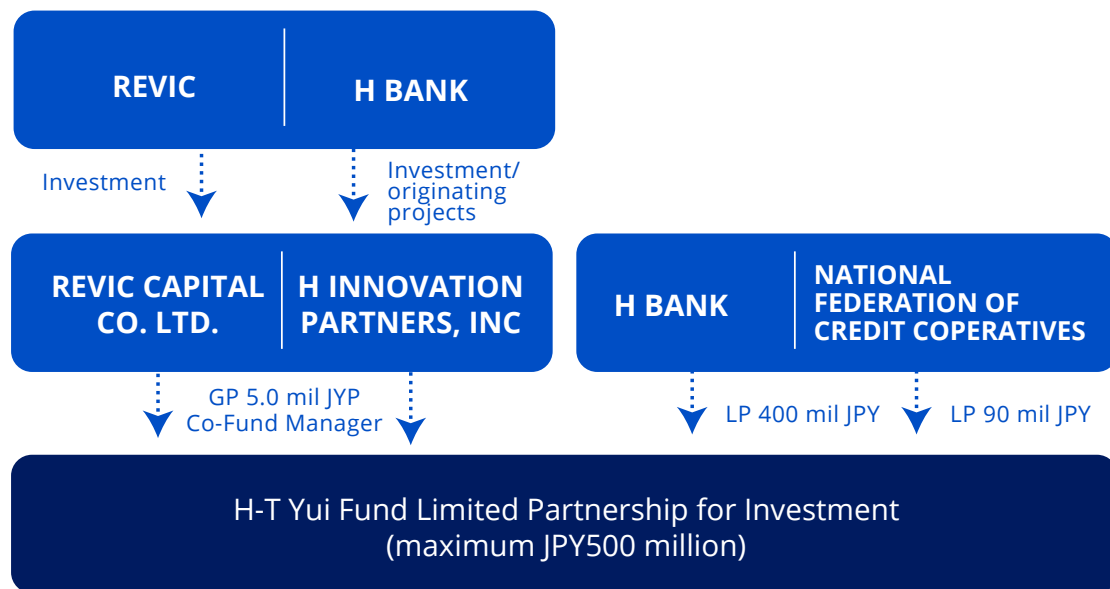
Compared to H City, T City has a higher share of the third sector, with many restaurants/bars for tourists. Jokamachi (a castle town) and Shokamachi (a town of traditional merchant houses) dating back to the Edo period⁵ are still preserved in the center of T City, and it is called a “Little Kyoto in the H City region” because of its historical streetscape. H-T region is a popular touristic destination with a lot of visitors from Japan and abroad coming every year. Approximately 4.34 million of tourists visited T City in 2015, 2 million of whom stayed overnight. Tours to the H-T region often include other touristic destinations nearby, such as Gero hot springs and Shirakawa-go (the historic village showcasing houses in the traditional building style known as “gasshō-zukuri”, registered as a UNESCO World Heritage Site in 1995), and T City is one of the hubs for such tours. Despite the increasing number of tourists, the number of those staying overnight is declining. The recent surge of foreign tourism is seen as a key contributor to the traffic increase, visitors from abroad accounting for 18% of the total overnight stays, which is 30% more than in 2014.

R1-2 OVERVIEW OF THE FINANCIAL SCHEME: H-T YUI FUND

Below is the structure of H-T Yui Fund Limited Partnership for Investment, set up and financed by H Bank.

⁵ The Edo period is the period between 1603 and 1868 in the history of Japan, when Japan was governed by the Tokugawa shogunate. The period was characterized by the economic growth, stratification of the society, national isolation policy, a stable population and a popular enjoyment of arts and culture.

FIGURE 6 OVERVIEW OF T CITY AND H CITY



Offering equity or bond capital to small and medium enterprises in T city, H city and Country

(Created by author)

TABLE 7 OVERVIEW OF H BANK

H BANK (H CREDIT UNION)	
Founded	September, 1949
Number of branches	16
Number of executives and regular employees	179
Equity capital	JPY 23.6 billion (USD 0.21 billion)
Number of members	26,821
Deposit portfolio	JPY 233.9 billion (USD 2.03 billion)
Loan portfolio	JPY 96.8 billion (USD 0.84 billion)

✓ **H-bank**

H Bank (H Credit Union) is a cooperative-structured financial institution, based in T City, H City, and O City in Gifu Prefecture. The purpose of the Union is to benefit its union members via mutual assistance and promote sustainable development of the local economy. Membership is available to the residents of the covered area and owners/employees of local MSMEs (credit unions are regulated by the Small and Medium Enterprise Cooperatives Act, enacted in 1949). Credit unions are supervised by the Financial Services Agency, like banks. Credit unions are smaller in scale than a typical commercial bank, they have close relationships with their clients (union members) who run MSMEs, often consulting them on their new business or particular transactions.

H Bank has been adopting various innovative approaches to satisfy the financial needs of the union members who are strongly engaged in promoting the local economy development. For instance, it opened a special consultation desk named “BizCon.H CITY” to educate the union members on management and marketing best practices. In addition, H Bank promotes alternative fundraising methods such as crowdfunding platforms. One example is a reward-based crowdfunding initiative FAAVO H-T, launched in cooperation with SEARCHFIELD Inc., which operates FAAVO, one of the popular crowdfunding platforms. H Bank supported fundraising for 17 projects on FAAVO (as of March 2016). H Bank acknowledges the new types of financial needs of its members, offering mid- and long-term equity-like capital on top of the conventional senior loans provided earlier. H-T Yui Fund Limited Partnership for Investment was established on 1 February 2015 specifically to meet such needs.

✓ **H-T Yui Fund Limited Partnership for Investment**

H-T Yui Fund Limited Partnership for Investment is co-financed by H Innovation Partners, Inc. (a subsidiary wholly owned by H Bank) and REVIC⁶ Capital (a subsidiary wholly owned by REVIC), acting as unlimited liability partners (General Partners, GPs), also financed by H Bank and the National Federation of Credit Cooperatives⁷ as limited liability partners (LPs). One of the important features of this fund is its association with REVIC, the first cooperative-structured financial institution in Japan. The two institutions have different roles: H Bank Group monitors the business progress based on a close relationship with the members on a daily basis, while REVIC is involved in the design of financing schemes, providing hands-on support with business planning and commercialization analysis.

H-T Yui Fund was established to promote revitalization and activation of the local economy through encouraging and supporting the local entrepreneurs, also aiming to increase the number of new businesses started. However, the H bank could not supply a sufficient MSME financing to the union members, who has a new business plan, by conventional senior loans due to the strict credit screening. H-T Yui Fund enables the provision of equity-like capital, which is similar to mezzanine loans in taking precedence over capital, but it has no voting rights attached to it and remains subordinate to senior loans. At the same time, it gives the lender access to the business to provide hands-on support in solving managerial problems over a long-term frame.

⁶ REVIC (Regional Economy Vitalization Corporation of Japan) was founded on December 14, 2009, formerly “Enterprise Turnaround Initiative Corporation of Japan (ETIC)” and the company was renamed “REVIC” in March 2013.

⁷ The National Federation of Credit Cooperatives was established in 1954 as the central bank for Japan credit cooperatives.

TABLE 8 PROFILE OF H-T YUI FUND

NAME OF THE FUND	H-T Yui Fund Limited Partnership for Investment
COMMITTED CAPITAL	JPY 50 billion (USD 0.43 billion)
FUND MANAGERS (CO-GP)	Regional Economy Vitalization Corporation of Japan (REVIC) H Innovation Partners Co., Ltd.
PERMITTED INVESTMENTS	Stocks (common shares, preferred shares), bonds (including convertible bonds) etc.
DATE OF ESTABLISHMENT	February 1 2015
DURATION	7 years from the Effective Date (31 December 2021)
MARGINAL REWARD	2.0% of the committed capital
INVESTMENT COMMITTEE	Two representatives of REVIC Capital Two representatives of H Innovation Partners
INVESTMENT RECIPIENTS	Second-tier firms and MSMEs, either headquartered or having branches in T City, H City or O District, Gifu, engaged in business which would help activate the region's economy.

REVIC is a Public-Private Investment Fund, supporting business activities to revitalize and activate the local economy. While directly offering loans or equity financing to a wide variety of companies in Japan, varying by industry and line of business, REVIC invests in funds in cooperation with provincial banks and other financial institutions (like in the case cited below). REVIC provides debt or equity finance and assigns consultants on business revitalization with a broad range of industry and business experience, to consult investees on management, finance or business operation strategies.

H Innovation Partners, Inc. acknowledges the benefit of launching a fund together with REVIC, as both its employees and the local financial institutions can learn from REVIC's expertise and experience.

The first fund was launched in February 2015 and was promptly invested, followed by the second fund in June 2016 (the total investment of JPY 500 million [USD 43 million], set a period of 10 years.) The number of investment projects is expected to increase in the near future.

TABLE 9 LIST OF LOAN/INVESTMENT INVESTEES OF THE H-T YUI FUND (AS OF NOVEMBER 11, 2016)

No.	CATEGORY OF BUSINESS	USE OF THE FUND	INVESTMENT VALUE	INVESTMENT FORM	INVESTMENT DATE
1	PROPERTY MANAGEMENT SERVICES	Development of a food stall village	46,000 (USD 0.4 million)	Bond	May 28, 2015
	AQUACULTURE	Purchase of equipment for aquafarming/Operation of a directly managed store	60,000 (USD 0.52 million)	Bond	Nov 13, 2015
	GLASSWARE MANUFACTURING	Purchase of equipment for production line	60,000 (USD 0.52 million)	Equity	Jan 4, 2016
	ELECTRICITY GENERATION	Construction of a hydroelectric power station	10,000 (USD 0.09 million)	Bond	March 7, 2016
	LIVESTOCK BUSINESS	Farmyard compost / Equipment for production of liquid fertilizer	150,000 (1.3 million USD)	Bond	April 25, 2016
2	PRODUCTION AND DISTRIBUTION OF HUMUS-RICH SOIL	Compost equipment	130,000 ((1.13 million USD)	Bond	August 31, 2016
Total of No. 1 and 2			456,000 (3.97 million USD)		

(Source: H Innovation Partners Co., Ltd.)

R1-3 OVERVIEW OF INVESTEES BUSINESS

1 Investee profile

TABLE 10 INVESTEE PROFILE

LOCATION	H-T Region
COMPANY NAME	S corporation, T city branch Co., Ltd.
FOUNDED	1961
DESCRIPTION OF BUSINESS PLAN)	Establishing the food stall village "D Yokochō" to revitalize the center of T City through culinary culture while developing the capacities of entrepreneurs
CAPITAL	JPY 16.9million (USD 0.15 million) as of 2009

2 Background information

S corporation, T City branch Co., Ltd. ("S corporation, T City branch") is a micro-enterprise, one of the affiliated stores of S corporation group (liquidated in 1998).

As the motorization rate increases, the lifestyle of local consumers is drastically changing, and so do the supermarkets, relocating their stores from urban areas to roadside suburban locations. S corporation, T City branch followed suit: around 2000, it relocated the store in A town, T City. The location was suitable, about a 9-minutes' walk from T City station; however, there were no prospects of profitability improvement in the future due to the limited floor space. There are some other issues (that CEO of S corporation, T City branch): low selling prices of the local produce, not matching its high quality (although the total sales volume was secured, the income of the local farmers remained unchanged); high start-up costs to launch a new restaurant, averaging around JPY 10 million [USD 86,957]. Many MSME operators gave up on potential projects, facing the difficulties in mobilizing the start-up capital. Then the idea of a food stall village was conceived, which could be a feasible solution and have a synergetic effect, lowering the initial costs by gathering micro food stalls together and offering the local produce at reasonable prices.

T City Shinkin Bank turned down the proposals for both the local farmers' market and the food stall village, unable to estimate the credit risks without a regional expertise. Later on, H Bank, known for its innovative approach to financial operations, positively evaluated the project concept of the food stall village business, using a forward-looking approach in their credit risk analysis, also expecting a positive impact on the local economy, such as an increase in the number of tourists staying over-night. The initial plan was to procure senior loans from the company's "main bank". However, the bank was cautious about extending debt financing to such kind of business. H Bank refinanced the existing senior loans from T City Shinkin Bank and procured equity-like capital by crowdfunding, intending it to be a cushion between the senior loans and equity. So, in a situation when S corporation, T City branch's main bank denied the company a loan, H-T Yui Fund Limited Partnership made a positive investment decision and financed the project.

3 Project Summary

In September 2015, the food stall village "D Yokochō⁸" was launched in A town, T City, with a maximum capacity of 21 tenants, on the site where the supermarket was previously located.

⁸ "Yokochō" means a corner with stalls and eateries. The name symbolizes the wish that the dream of visitors and shop owners come true.

FIGURE 7 D YOKOCHO



D Yokochō, start-up and maintenance costs (1 stall is 9.9 m2)

AMOUNT	JPY 46,000,000(USD 400,000)
USE OF FUND	Food stall village construction.
PAYMENT METHOD	Bullet repayment at maturity.
DURATION	7years
INTEREST RATE	Approx4%
SECURITY/GUARANTOR	No security/No guarantor

Compared to the start-up costs for conventional restaurants in the city, D Yokochō offers lower initial and running costs. S corporation, T City branch supervises overall management of each tenant in the food stall village, advising on the financial and business strategy, marketing activities and events.

4 Summary of Funding

S corporation, T City branch issued private placement bonds to the total of approx. JPY 46 million (USD 400 k), purchased by H-T Yui Fund, with the proceeds earmarked for the food stall village construction.

TABLE 11 PRIVATE PLACEMENT BOND TERMS OF ISSUE

AMOUNT	JPY 46,000,000(USD 400,000)
USE OF FUND	Food stall village construction.
PAYMENT METHOD	Bullet repayment at maturity.
DURATION	7years
INTEREST RATE	Approx4%
SECURITY/GUARANTOR	No security/No guarantor

R1-4 FINDINGS FROM THE SUCCESSFUL FUNDRAISING AND ROLES OF STAKEHOLDERS

☑ **Financial institution (H bank)**

Clearly defined policy for revitalizing of local economy.

Conventional private equity investment funds such as venture capital funds normally target the maximum short-term capital gain, realized at IPO. However, H-T Yui Fund does not aim at a short-term capital gain, but rather at setting up a stable stream of income from the local MSMEs steadily growing in the long term growth. In the case of S corporation, T City branch, H Bank stipulated the conversion of the remaining loan into a senior loan, if the privately placed bonds are not fully redeemed at maturity (in seven years). This reaffirms H Bank Group's intention to prioritize long-term business relationship with the companies. The 4% interest rate for the privately placed bonds was not thought of as an appropriate risk premium for debt financing, but rather to cover the running costs of the funds and secure an equivalent investment return to the bank's other invested assets.

This is largely related to the bank's policy, prioritizing the prosperity of the community, the client and the financial institution, advocating the CSV (Creating Shared Value) management as a local bank in the H-T region. The ripple effect on the local economy is one of the key criteria for the investment decisions made by H-T Yui Fund. Not only single entities should benefit from the investments – throughout the screening process, the positive effect on the local community is evaluated, based on MSMEs' business activities.

Integrated network of the H Bank Group in the H-T region.

According to CEO of the S corporation, T City branch, the H-T region is known for its exclusive and closed culture in the local communities,

focusing on family, relatives and friends. H Bank group takes advantage of this local network, accessing the reliable information on the investee's profile, history and business performance. It also helps to mitigate the credit risk, which the bank is carefully monitoring and takes prompt measures to hedge.

✓ **Partner investor (REVIC)**

Providing expertise and sharing best practice.

REVIC is engaged in a lot of business revitalization or regional activation projects nationwide, covering a wide range of industries and business fields. REVIC supports several types of business support activities: 55 funds, 91 projects for corporate revitalization, 166 projects of managerial support and 133 experts on temporary assignments. Its ability to evaluate the prospects of a business is based on experience and expertise. REVIC is also actively hiring experts in business revitalization or management consulting, which is valuable for the local financial institutions such as H Bank.

During the start-up and the early growth stage, many of MSMEs usually encounter numerous problems they have not dealt with before. Prompt professional advice is essential to address those problems. REVIC's experts consult on business revitalization and provide management support for MSMEs operators in a "hands-on" manner. In the case of S corporation, T City branch, REVIC was able to offered timely advice on management. The expertise and information from REVIC add considerable value to H-T Yui Fund.

✓ **H Innovation Partners, Inc.**

Business plan-oriented investment

Unlike conventional corporate loans, H-T Yui Fund does not put the main focus on the collateral or guarantee, but evaluates the credibility of company's business plans and the potential positive impact on the local economy.

Based on the investee's business plan, H Innovation Partners, Inc. makes a feasibility analysis. REVIC complements the process of due diligence, advising on how to improve the business plans. Once the new business commences, each investee submits a cash flow statement and a trial balance to H Innovation Partners, Inc. and REVIC on a monthly basis. Based on these documents, the relevant stakeholders hold monthly discussions, monitoring the business and taking the necessary measures as required. Throughout the process, the business plan is further improved, contributing to higher revenues.

Reference2: Present State of Financing to MSMEs and Business Start-ups in Japan

Reference 2 describes present state of finance to MSMEs and entrepreneurs in Japan. Generally, financing these parties is considerably affected by industrial development, financial and other policies of the government. Thus, this chapter refers to the general policies and regulations adopted by the Government of Japan to promote financing to MSMEs and entrepreneurs. The chapter also provides an overview of the risk analysis mechanism in financial institutions because the financial system in Japan, as those in other countries, has a remarkable impact on financing MSMEs and entrepreneurs.

R2-1 THE PRESENT STATE OF MSME FINANCING IN JAPAN

R 2-1-1 The Present State of Financing to MSMEs in Japan

In Japan, where depopulation is becoming a reality, the vitalization of business start-ups and innovations are considered to be extremely important for the future sustainable economic growth. As part of its efforts to strengthen the mechanism to financing MSMEs and ventures, the Cabinet of Prime Minister Shinzo Abe approved “Japan Revitalization Strategy⁹” of June 14 2013, as the third “arrow” of its economic policy package termed “Abenomics”. This growth strategy emphasizes the importance of MSME financing, incorporating various policies to facilitate more investment and reinvestment in ventures and entrepreneurs. The Japan Revitalization Strategy stresses the role of individual investors in the MSME financing, offering measures to support them under the slogan “from savings to investment”. While the strategy states that the economic growth should be led by the private sector, it also proactively utilizes public funds as an incentive to encourage the private financial sector to MSME financing. As part of this policy since the inauguration of the current Abe’s administration, the public sector has established several public-private investment funds to stimulate the MSME financing.

MSME financing takes various forms including stocks, debt securities and loans, but the degree of their risk varies depending on companies to be financed, the nature of their business activities, duration and other conditions, so the report will not limit the MSME financing only by the forms of funding.

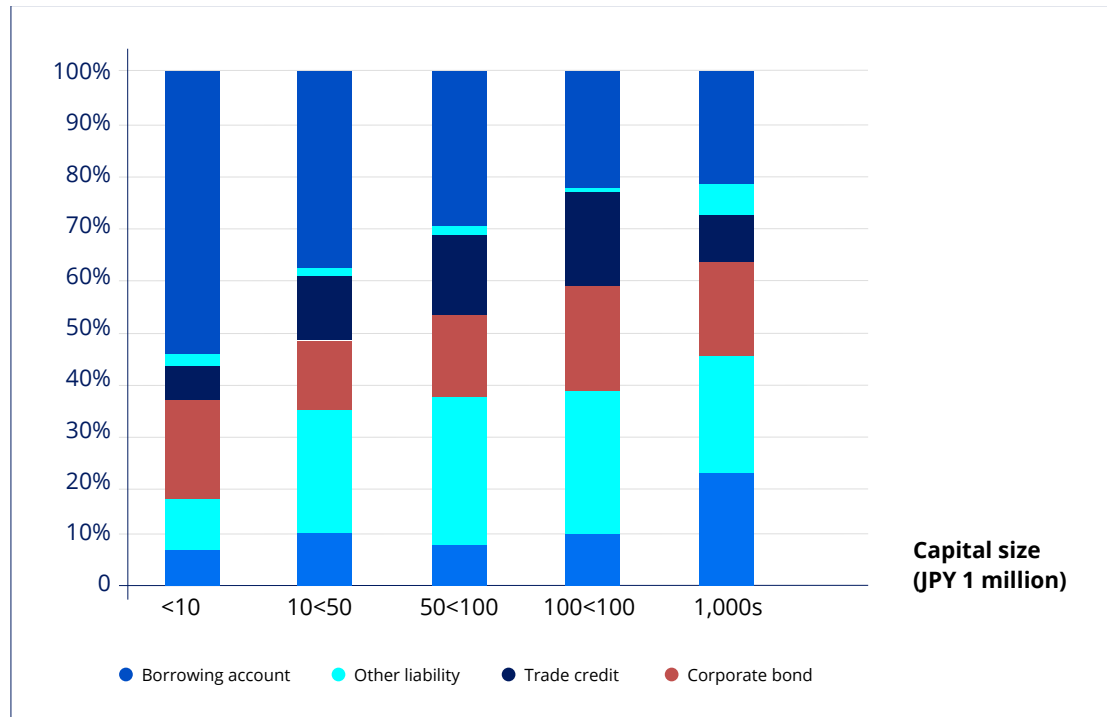
R 2-1-2 Capital Demands of MSMEs and Ventures

After experiencing the burst of the bubble economy and the subsequent financial crisis in the 1990s, Japanese businesses have sought to strengthen their financial structures. As a result, the share of their equity capital has increased

⁹ The strategy consists of the 3 arrows, the first arrow is bold monetary policy, the second arrow is flexible fiscal policy and the third is “Japan Revitalization Policy”.

and external debt including bank loans has gradually reduced. This trend is especially conspicuous among the larger companies: borrowing accounts for a mere 20% of the total Liabilities and Shareholder's Equity on the balance sheets of companies with the capital of JPY 1 billion [USD 8.7 million] (hereinafter the rate of JPY 115 per USD 1 is used) or more. This shows that the demand for MSME financing stagnates.

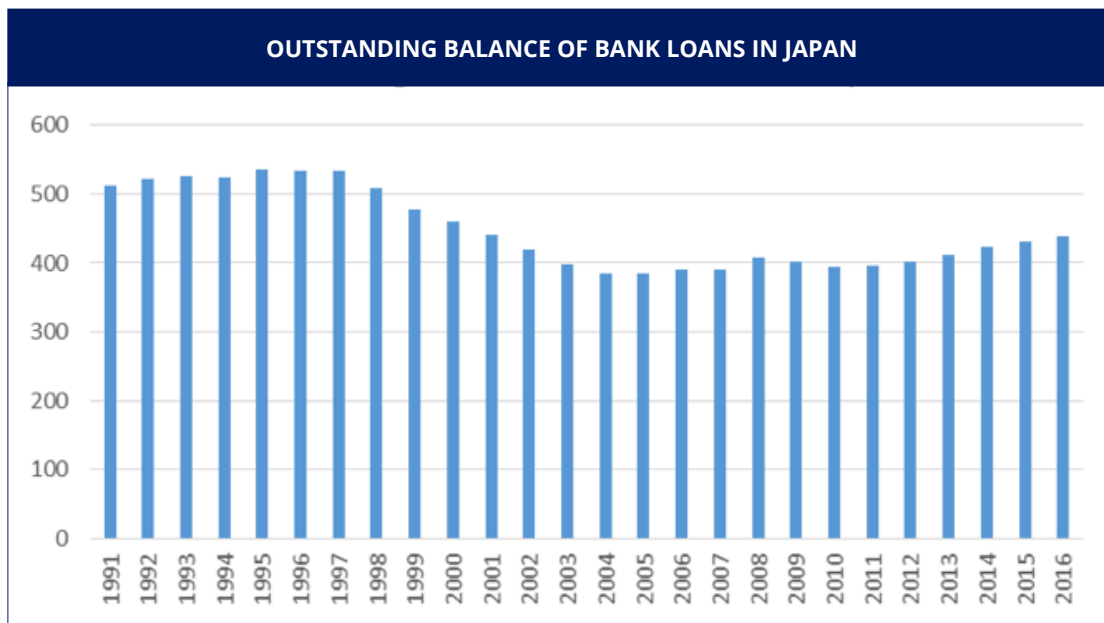
FIGURE 8 COMPONENTS OF LIABILITIES AND CAPITALS OF JAPANESE COMPANIES (ALL INDUSTRIES)



On the other hand, the financial condition of MSMEs is generally more fragile than that of large companies; they often have difficulties in raising capital in the market and usually rely on borrowing from financial institutions (indirect financing). Japan's MSMEs opt to borrow money from financial institutions partly because the indirect financing system is still dominant in accordance with the policies adopted by the Japanese Government in the post-war period.

Moreover, quite a few ventures that are too small to be covered by corporate statistics will likely have difficulties even in accessing bank loans, so they rely on paid-in capital. The table below presents the outstanding balance of bank loans (including major, regional and second-tier regional banks) in Japan since 1990. It shows a downward trend after around 1995 but a slightly increase after around 2013 when the Bank of Japan started monetary easing measures.

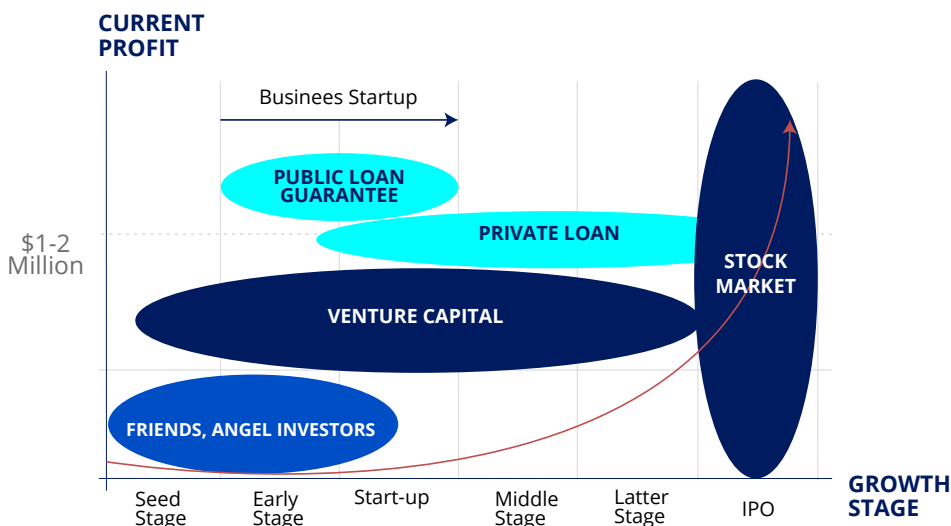
FIGURE 9 OUTSTANDING BALANCE OF BANK LOANS IN JAPAN



(Source: Website of Bank of Japan)

Next, let us have a look at venture capital (“VC”) as a source of financing for fledgling businesses and those on an early growth stage. VC is defined as financing that investors provide to private non-listed, small and medium-sized ventures that are believed to have a strong growth potential. The financing takes the form of stocks, convertible bonds, bonds with warrants and other types of equity instruments and equivalents. Generally, VC provides necessary money to start-up businesses at an initial or early growth stage, and exits the investment by means of an IPO. In other words, VC recovers its investments in ventures by selling their stocks in the stock market at the most appropriate time after the IPO. VC investors may also recover their investments through strategic deals (M&A).

FIGURE 10 TYPES OF FUNDING AND GROWTH STAGE OF VENTURES

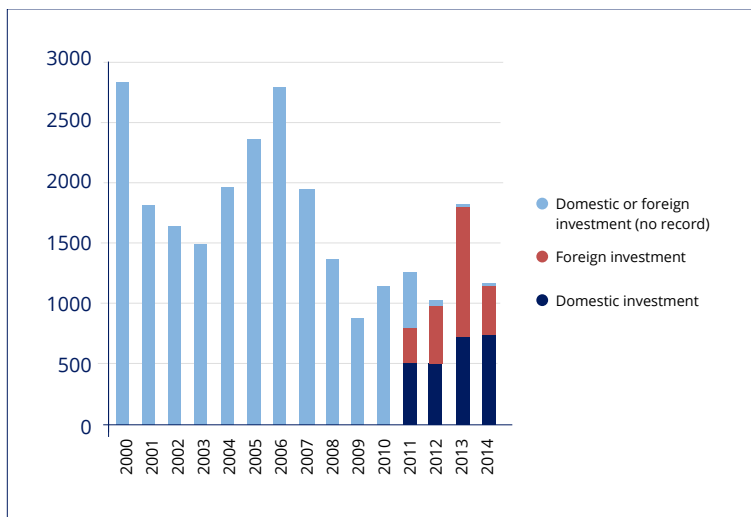


(Source: Website of Shinkin Capital Co., Ltd.)

In 2014, Japan's VC investment totaled approximately JPY 117.1 billion [USD 1 billion], of which JPY 74 billion [USD 643 million] was in domestic businesses, JPY 41.8 billion [USD 363 million] in overseas businesses, and JPY 1.3 billion [USD 11 million] was not attributed¹⁰.

IPO market remains stagnant since the global economy went down following the bankruptcy of Lehman Brothers. Although, a number of IPOs in the domestic market has taken place, being a sign of recovery, the volume of domestic VC investment with exit strategy via an IPO has not returned to the pre-2008 levels.

FIGURE 11 TOTAL INVESTMENT AMOUNT OF VENTURE CAPITALS¹¹



(Source: Venture White Paper 2015)

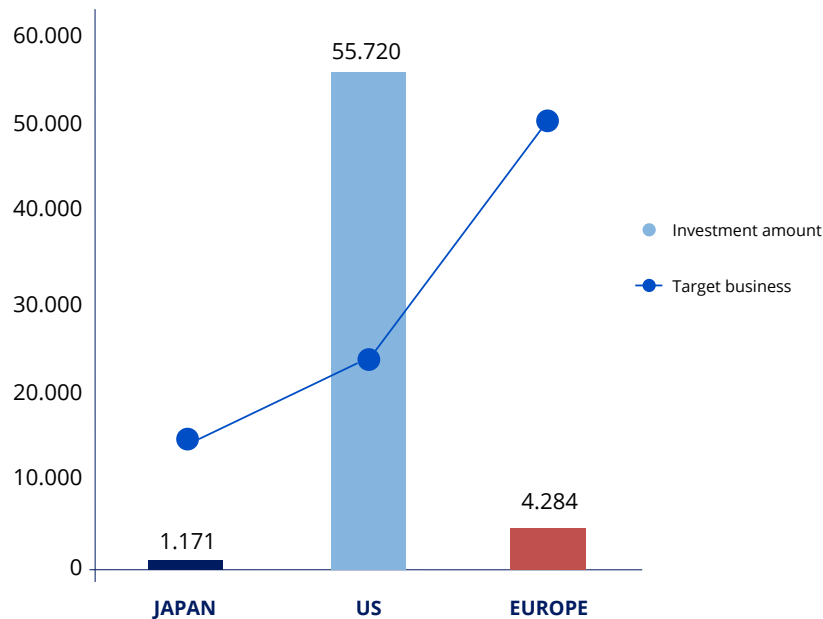
The following chart compares the size of Japan's venture capital market with those of the U.S. and Europe, showing it is much smaller. This is because the average amount of investment per business is smaller, because the proportion of venture capitals established by financial institutions is larger, and also because there are not so many venture capitals with extensive knowledge and rich experience of venture investment in Japan.

¹⁰ Venture White Paper 2014 (Venture Enterprise Center of Japan)

¹¹ The investment amount had not been classified in terms of destination until 2010, but started to be classified into business in Japan and those abroad in 2011.

FIGURE 12 COMPARISON OF THE VC INVESTMENT AMOUNT AND TARGET BUSINESSES AMONG JAPAN, THE U.S. AND EUROPE (INVESTMENT AMOUNT ON THE LEFT-HAND AXIS, AND THE NUMBER OF TARGET ENTERPRISES IN THE RIGHT-HAND AXIS)

(Unit: JPY 100 million)



(Source: Venture White Paper 2015)

In 2013 in Japan, the General Startup Index¹² which shows startup dynamics, was 3.7% - compared to 12% in the USA. Therefore, the low activity of startups in Japan results in the low demand for MSME financing.

As described above, the demand for MSME financing saw a slight recovery due to the monetary easing measures taken by the Bank of Japan and a subsequent increase in corporate loans from financial institutions, but is still sluggish among large companies, MSMEs and ventures in Japan.

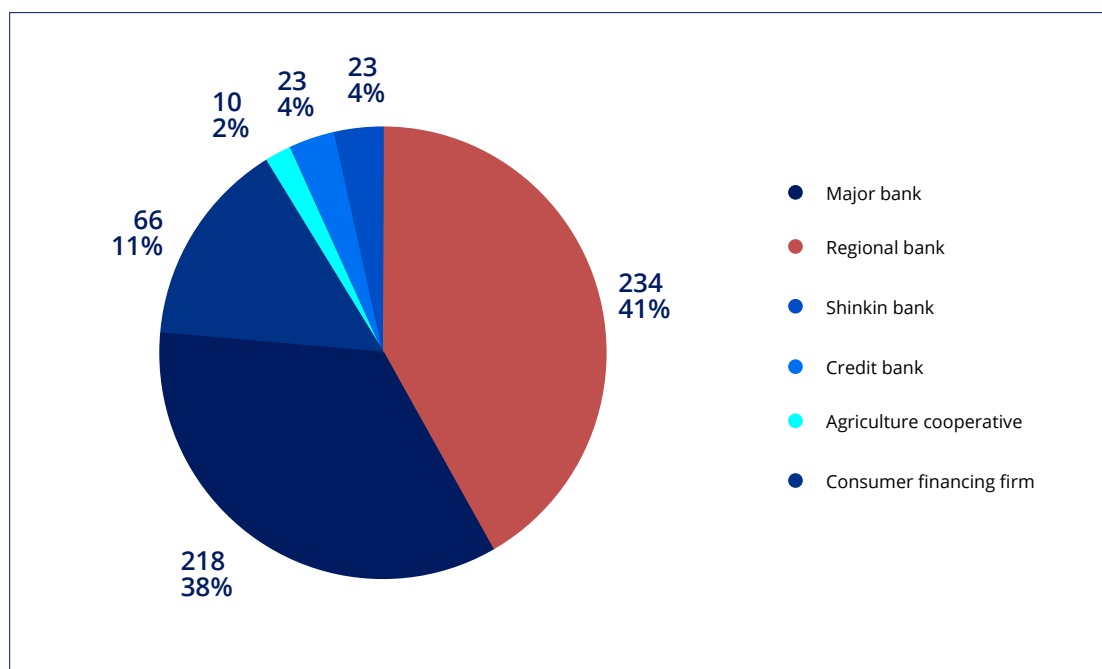
As for the financial institutions where MSMEs and ventures can borrow MSME financial institutions, major banks have the largest loan portfolio, followed by regional banks and Shinkin banks (regional financial institutions chiefly for MSMEs and local residents). In 2014, the total outstanding balance of loans provided by these financial institutions was JPY 573 trillion [USD 5.0 trillion]¹³. Most commonly financial services to local MSMEs are provided by the regional financial institutions, regional and Shinkin banks, and credit unions.

¹² International Searching for Entrepreneurship and Venture Report in 2013, Venture Enterprise Center

¹³ According to the website of the Financial Services Agency and Journal of Agricultural and Forestry Financing", Norinchukin Research Institute Co., Ltd.

FIGURE 13 TYPES OF FINANCIAL INSTITUTIONS IN THE LOAN MARKET

(Unit: JPY trillion)



(Source: Corporation Statistics, Ministry of Finance)

TABLE 12 OVERVIEW OF JAPANESE FINANCIAL INSTITUTIONS BY TYPE

TYPE	OVERVIEW
MAJOR BANK	Regulated by the Banking Act. A major bank normally has its head office in a metropolitan area and branches in wider areas. Has strong relations with large companies. There are currently four major banks in Japan: the Bank of TokyoMitsubishi UFJ, Sumitomo Mitsui Banking Corporation, Mizuho Bank and Resona Bank.
REGIONAL BANK	Regulated by the Banking Act. A regional bank has its head office in a certain prefecture and operates at the local level. As of 12 November 2016, there are 64 regional banks and 41 local banks. There is no difference in operations between the regional and the local bank except for the covered area.
SHINKIN BANK	Regulated by the Shinkin Bank Act. A Shinkin bank, unique to Japan, is a nonprofit regional financial institution seeking to promote regional economic growth. As of 31 March 2016, there are 265 Shinkin banks in Japan.

TYPE	OVERVIEW
CREDIT UNION	Regulated by the Small and Medium-Sized Enterprise Cooperatives Act. A credit union is a non-profit financial cooperative that provides financial services to its member MSMEs. As of 1 October 2016, there are 163 credit unions in Japan.
AGRICULTURAL COOPERATIVE	Regulated by the Agricultural Cooperative Act. The Agricultural Cooperative (alias: JA Bank) is a commercial corporation that provides financial services chiefly to member farmers. As of 31 March 2016, JA Bank has 8,010 branches.
CONSUMER FINANCING FIRM	Regulated by the Moneylending Control Act. A consumer financing firm provides unsecured loans, mostly to individuals. Some consumer financing firms provide loans to micro businesses.

Other than those listed above, governmental financial institutions also play an important role in providing financing to MSMEs in Japan. Among them, Japan Finance Corporation (JFC) and Development Bank of Japan (DBJ) which provide equity and debt financing to them. Particularly after the Great East Japan Earthquake in March 2011, JFC and DBJ provided MSME financing for the rehabilitation of affected areas and played a crucial role in assisting the government-led development of the private sector.

TABLE 13 OVERVIEW OF JFC AND DBJ

TYPE	OVERVIEW	LOANS OUTSTANDING
JAPAN FINANCE CORPORATION (JFC)	Established in 2008 as the result of the merger of four governmental policy-based financial institutions, including National Life Finance Corporation; Agriculture, Forestry and Fisheries Finance Corporation; and Japan Finance Corporation for small Business. JFC provides financing services to MSMEs in Japan. Regulated by the Shinkin Bank Act. A Shinkin bank, unique to Japan, is a non-profit regional financial institution seeking to promote regional economic growth. As of 31 March 2016, there are 265 Shinkin banks in Japan.	JPY 18.7 trillion [USD 162 billion] (as of March 2016)
DEVELOPMENT BANK OF JAPAN (DBJ)	Established in October 2008 as the result of the merger of Rehabilitation Finance Corporation, Japan Development Bank, Hokkaido-Tohoku Development Finance Public Corporation, and former Development Bank of Japan. DBJ provides unique financial services such as senior loans, mezzanine loans and equity investments, mostly to large companies	JPY 13.1 trillion [USD 113 billion] (as of the end of March 2016)

R2-2 IMPROVEMENTS IN POLICIES AND THE LEGAL FRAMEWORK TO PROMOTE PROVISION OF FINANCING TO MSMEs AND VENTURES IN JAPAN

R2-2-1 Overview of the Legal Framework to Financing MSMEs and Ventures.

As already described, in post-war Japan, the financial sector was developed with a focus on indirect financing. Partly because of this, the demand for MSME financing including debt financing is sluggish in the Japanese business scene as a whole. In particular, there are difficulties in matching the ventures and MSMEs looking for money with VC and angel investors in terms of investment period and expected return. Moreover, compared to other countries, the share of risk assets in household accounts is low in Japan¹⁴, where the indirect financing remains dominant even nowadays.

In such circumstances, it is recognized that Japan's financial system cannot smoothly supply enough MSME financing.

In light of this, the Government of Japan has launched "public-private investment funds", jointly funded by the government and the private sector in line with the governmental policies for supplying more MSME financing, which private financial institutions alone cannot supply due to the high risk. The Cabinet Secretariat established an advisory committee to monitor the existing public-private investment funds and discuss the system and the design of funds to be newly created. In 2013, the Cabinet Secretariat released its "operational guidelines for public-private investment funds".

The purpose of these public-private investment funds is to encourage individual investors to more actively take business risks they are reluctant to take alone. Another purpose is to indirectly support private initiatives for economic growth by attracting private investment and reducing the fiscal burden.

Public-private investment funds are expected to produce the following four effects¹⁵.

- ④ Induce private investment through the MSME financings that the private financial sector has difficulty in providing on its own (pump-priming effect).
- ④ Reduce the volume of capital injections from public funds required by business startups by means of equity financing and subordinated lending (leverage effect);

¹⁴ According to "Chosa Kiho (Quarterly Research Journal)", Spring 2014, Daiwa Institute of Research, the share of stocks and investment in financial assets of households is approx. 50% in the U.S., and around 30% in the U.K., France and Germany, while that in Japan is a mere 14%.

¹⁵ Source: "About Public-Private Funds", resources on the website of the Ministry of Defense

- ☑ Avoid unnecessary governmental commitment to business, and alleviate the fiscal burden and the business risks borne by the government by utilizing private initiatives, vitality and financial resources, and setting out an exit policy (selling and/or listing MSMEs' and ventures' stocks after a certain period, assigning loan portfolios to the private sector, etc.) (reduction of public fiscal burden); and
- ☑ Fostering financial institutions by leveraging financings to support MSMEs business operations and project development (guiding and fostering).

Public-private investment funds are required to effectively implement the governmental policy and secure profits for the private sector, which could be hardly achieved by the public or private sector alone. To do this, it is important to (i) make fund operations consistent with the policy objectives; (ii) appropriately choose and monitor businesses to be invested in; (iii) secure the transparency and timeliness of disclosures after investment; and (iv) create synergetic effects with the private sector and efficient operations.

Public-private investment funds need to have appropriate screening and risk management functions, including the following characteristics, and secure profitability¹⁶.

TABLE 14 CHARACTERISTICS OF PUBLIC-PRIVATE INVESTMENT FUND SCHEME

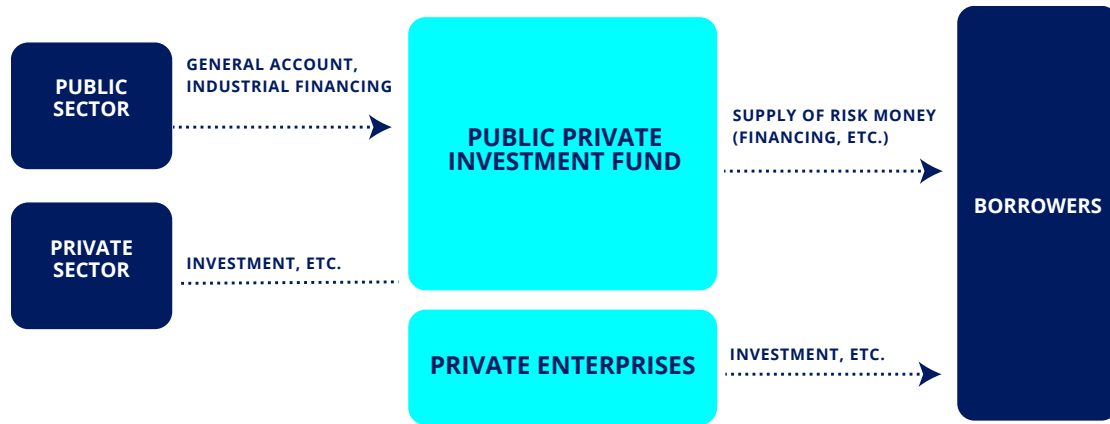
1	Private sector investment professionals and know-hows are used for the exploration of investment targets and their due diligence.
2	An investment committee including external directors from the private sector makes investment decisions from the neutral viewpoint.
3	Post-investment monitoring arrangements are properly made, based on Key Performance Indicators (KPIs) and other indexes to evaluate policy objective fulfillment. The arrangements are also designed to ensure the separation of the assessment function from the decision-making function to appropriately assess the investment policies.

(Source: prepared by DTFA)

Each public-private investment fund's lifetime is fixed by a special law to limit investments and allow the private sector to take over its functions in the future. However, because the objectives of public-private investment funds include achievement of policy objectives, their lifetime tends to be longer than that of the ordinary private funds, so that investment decisions could be made from the mid- and long-term perspectives.

¹⁶ Source: "Supply of Risk Money through Public-Private Funds", a column in "2014 Report on Financial Treasury Investments and Loans" on the website of the Ministry of Finance

FIGURE 14 PUBLIC-PRIVATE INVESTMENT FUND SCHEME¹⁷



Source: Website of the Ministry of Finance

TABLE 15 LIST OF MAJOR PUBLIC-PRIVATE INVESTMENT FUNDS (TARGETS OF INDUSTRIAL INVESTMENT)

DATE OF ESTABLISHMENT	FUND NAME	PURPOSE OF ESTABLISHMENT	FUND SCALE (JPY 100 MILLION)
JULY 2009	Innovation Network Corporation of Japan (INCJ)	Encouraging openinnovation through incubation of industries in the next generation, and increasing the national wealth	Government funding 2,860 Government guarantee: 18,000 Private sector: 140
OCTOBER 2009 (FUND RENAMED IN MARCH 2013)	Regional Economy Vitalization Corporation of Japan (REVIC)	Reconstructing regional economies through supporting business realignment and activities contributing to vitalization of regional economies	General account: 30 Fiscal Investment: 100 Government guarantee: 10,000 Private sector: 101
JULY 2004	SMEs Growth support fund of Organization for Small & Medium Enterprises and Regional Innovation, Japan	Supporting startups, growth and business realignment of SMEs	General account: 157
JANUARY 2013	Agriculture, forestry and fisheries Fund Corporation for Innovation, Value chain and Expansion, Japan (A-FIVE)	Supporting businesses jointly invested in by an agricultural, forestry or fishery business and a business in other industry seeking business in the "sixth sector industry" ¹	Government funding: 300 Private sector: 19
NOVEMBER 2013	Cool Japan Fund Inc.	Supplying MSME financing to support overseas expansion of enterprises intending to provide Cool Japan products and services in overseas market, and induce private investment in this field	Government funding: 300 Government guarantee: 115 Private sector: 115
MARCH 2013	Fund for Japanese Industrial Competitiveness (Development Bank of Japan, DBJ)	Supplying MSME financing for operations to create new values and improve corporate values, which can help enhance Japan's competitiveness.	Governmental loan: 1,000 Private sector: 500

¹ The sixth sector industry is a primary producers' diversification into processing and distribution

¹⁷ Public-private investment funds alone can provides finance without involving private sector investors in case deemed it necessary.

R2-3 ARRANGEMENTS OF FINANCIAL INSTITUTIONS IN RESPONSE TO FINANCING DEMAND FROM MSMEs AND ENTREPRENEURS IN JAPAN

R2-3-1 Arrangements of Financial Institutions in Relation to New Means of Financing in Japan.

This section outlines specific arrangements of financial institutions to financings MSMEs, ventures and businesses of other forms.

1 Equity-Capital-Like-Loan (ECLL)

Currently, Japan's private financial institutions, as well as governmental financial institutions (such as Japan Finance Corporation, Development Bank of Japan and Norinchukin Bank), are increasingly providing Equity-Capital-Like-Loan (ECLL) as a new means of financing. The scheme of ECLL originally aimed to support businesses that saw a temporary aggravation of business performance, but is now used for various purposes and businesses, including emerging companies and those seeking to reconstruct their business operations.

Until recently, MSMEs and fledgling companies had difficulties in accessing financing, some claiming that they cannot obtain loans from private financial institutions until they manage to record a certain level of sales and move into the black, and that their business operations could be restricted if they rely on venture capital too much and its share becomes too large.

This scheme has made it possible for these businesses to access long-term financing and improved their quasi-equity capital and credit capability without lowering the stock ownership ratio amongst their existing shareholders, because ECLL is not equity. The scheme is also advantageous to financial institutions because it can raise the credit score of borrowers, so that they do not need large reserves and can obtain support from other financial institutions because of subordinated borrowing¹⁸.

The FSA cites as examples of ECLL "Special Loans for Support for Business Start-ups and Regional Revitalization" and "Disaster Response Subordinated Loans" of Japan Finance Corporation, and "Loans Recognizable as Capital" of MSME Revitalization Support Councils. The FSA also stipulates that borrowings from financial institutions other than these two institutions can be recognized as "borrowings with the sufficient nature of capital" if such borrowings satisfy certain conditions – that is, for example:

- ☑ The borrowing is not required to be repaid specifically over five years;
- ☑ The relevant interest rate can be set in proportion to divisible profit;

¹⁸ Guide for Use of Loans Recognizable as Capital", pages 4-9, Japan Finance Corporation, 2014.

- ④ The borrowing is subordinated in case of legal bankruptcy¹⁹.

TABLE 16 MAJOR SCHEMES OF BORROWING RECOGNIZABLE AS CAPITAL

FINANCIAL INSTITUTION	SCHEME	BORROWER	CREDIT LINE
JAPAN FINANCE CORPORATION	Special Loans for Support for Business Startups and Regional Revitalization (Operations aimed at micro businesses and individuals)	MSMEs engaging in startups, new business, overseas operations, business revitalization, etc., whose operations are expected to generate the employment effect of a certain degree to vitalize regional economies, essential for the local community, or committed to business requiring high technical capability	JPY40 million [USD 350 thousand]
	Special Loans for Support for Business Startups and Regional Revitalization (Operations aimed at MSMEs)	Businesses using New Business Development Loans, Loans for Enhancing Corporate Validity or Corporate Revitalization Loans out of the JFC direct loan schemes, whose operations are expected to generate the employment effect (job creation or maintenance) of a certain degree to vitalize regional economies, essential for the local community, or committed to business requiring high technical capability	JPY300 million [USD 2.6 million]
	Loans Recognizable as Capital (Operations aimed at agriculture, forestry, fisheries and food business)	Agricultural, forestry or fisheries businesses engaging in newly development business operations (available to corporate persons only)	The amount necessary to make the deemed capital adequacy ratio 40%, or JPY 100 million [USD 870 thousand], whichever is lower

2 New venture capitals (Case of Shinkin Capital Co., Ltd.)

Until recently in Japan, business startups commonly raised financing from credit guarantee corporations²⁰, together with their own capital.

In Japan, meanwhile, there is an institutional difficulty in developing financial assistance for business start-ups because of two reasons. The first one is related to the characteristics of Japan's corporate activities. In Japan, highly advanced and complicated distribution networks and manufacturing know-hows are usually in possession of large companies, and business start-ups aiming to release new products and unique services to satisfy customer needs are also from large companies. This indicates that business start-ups can obtain support from large companies if they develop new products and services satisfying

¹⁹ "FAQ about the Financial Inspections Manual (revised sections)", page 12, Inspection Bureau, FSA, 2011.

²⁰ Public organizations based on the Credit Guarantee Association Act. Located in the prefectures and some cities in Japan, Credit Guarantee Corporations complement the credit and guaranteeing capabilities of private businesses for smoother financing for SMEs.

customer needs, but it is difficult to start business if the purpose is to develop products and services that do not attract interest of large companies. The second reason is that Japan saw the development of VC in line with the global trend, but Japan's VC has become designed for large-scale restructuring plans to rehabilitate large and medium-sized companies with high possibility of debt collection, high potential growth and certain size, rather than for assistance to business start-ups in wider areas.

Among VC suppliers, organizations supervising financial institutions of a particular industry or region (central cooperative financial institutions) are beginning to set up more and more business start-up funds for particular regions to vitalize the regional communities, suffering from population decrease and ageing. Because such central cooperative financial institutions are likely to come into conflict²¹ with financial institutions that provide credit²², they normally set up funds to be operated at their own discretion to supply long-term loans.

For example, Shinkin Central Bank, a central financial institution for the regional cooperative financial institutions, has established a 100% subsidiary called Shinkin Capital Co., Ltd., through which the bank provides financial services for MSMEs. Shinkin Capital is actually a venture capital but its parent bank is a non-profit cooperative for regional growth through mutual aid. In other words, Shinkin Capital primarily aims at supporting the regional economies by contributing to its regional members, rather than seeking short-term profits²³. In this sense, Shinkin Capital is different from a typical VC that pursues short-term capital gains, high dividends and high internal rate of return, but still is a form of VC.

TABLE 17 OVERVIEW OF SHINKIN CAPITAL

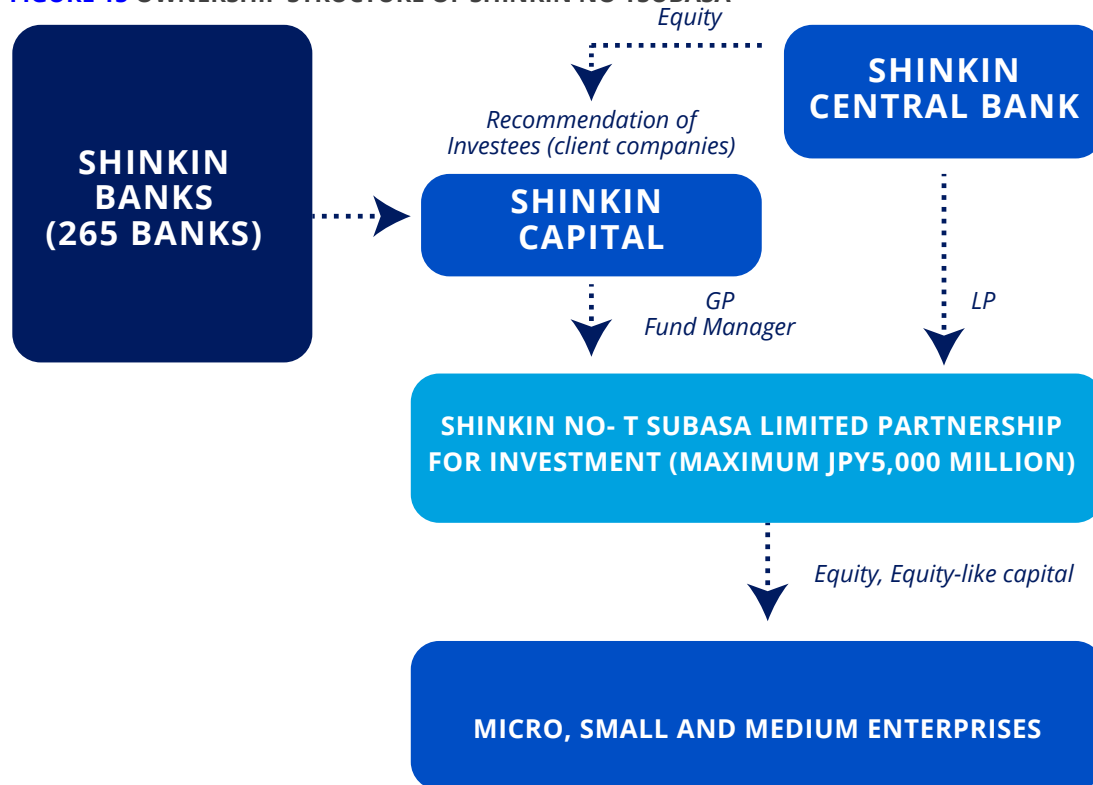
NAME	SHINKIN NO TSUBASA LIMITED LIABILITY INVESTMENT PARTNERSHIP
LOAN SCALE	JPY 5 billion [USD 43 million]
INVESTORS	<ul style="list-style-type: none"> <li data-bbox="687 1509 1246 1547">☑ Unlimited liability partner Shinkin Capital Co., Ltd. <li data-bbox="687 1585 1198 1624">☑ Limited liability partner Shinkin Central Bank
LIFESPAN	10 years (of which investment period is 5 years)
RENT/MONTH INVESTMENT INSTRUMENTS	Common shares, preferred shares, subordinated debt, etc.

²¹ Central cooperative financial institutions finance businesses, hoping that the fund will facilitate corporate growth or improvement in shareholders' value, rather than hoping to collect the loan. Because of this, they often come into conflict with credit providers.

²² They refer to regional financial institutions, which are required to collect funds within due periods.

²³ Corporate information on the website of Shinkin Capital Co., Ltd. (confirmed on November 9, 2016)

FIGURE 15 OWNERSHIP STRUCTURE OF SHINKIN NO TSUBASA



(Created by author)

Shinkin Capital provides pro forma venture capital – that is, it gains profit by selling shares in the borrowing businesses after they put their business performance back to normal or get listed in the mid- and long term – but it also finances the businesses that are too small to be listed, rendering business consulting services. Shinkin Capital, though providing MSME financing, takes a policy of not prioritizing high returns, and supports sustainability of businesses in accordance with their growth phases, helping them formulate future scenarios (support for listing, business continuation, etc.) and utilize preferential shares (with no voting rights for five years). The following table compares characteristics of common VCs and Shinkin Capital.

TABLE 18 COMPARISON BETWEEN COMMON VCS AND SHINKIN CAPITAL

	COMMON VC	SHINKIN CAPITAL
AIM	Short-term buyout with high return	Not expecting high return but supporting local enterprises
PURPOSE	High dividend and high interest rate	Growth potential in a long term
VALUE UP	Only an economic value	Not only an economic value but its social value is also considered
SHAPE TYPE	Mainly common shares	Preferential shares (a limited term to be free from voting right)
STAGE	Mainly from preparation to startup stages	From preparation to growth stages
SIZE OF TARGET BORROWER	The larger corporate size is preferable	Small-sized enterprises are also the target

(Source: Website of Shinkin Capital Co., Ltd)

R2-3-2 Viewpoints of Financial Institutions in Relation to Means of New Financing, and Comparison of MSME financings

The previous section highlighted Equity-Capital-Like-Loan (ECLL) and Shinkin Capital as the new types of operations of financial institutions in Japan. This section will examine issues on each stage of new business.

As illustrated in the following table, businesses chiefly use own capital, loans from governmental or private financial institutions, or subsidies - when they are preparing for actual startups.

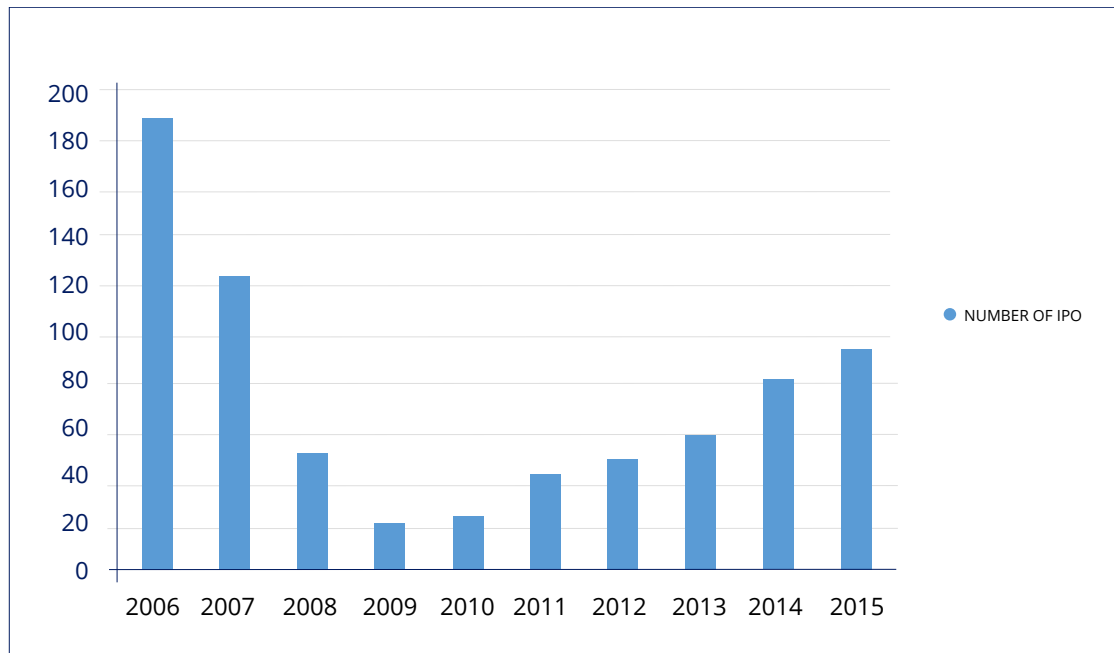
FIGURE 16 FUND-RAISING METHODS FOR BUSINESSES AT EACH BUSINESS STAGE

STAGE	PREPARATION	STARTUP	GROWTH	BUSINESS BASE ESTABLISHMENT
CONVENTIONAL FUND-RAISING METHOD	Own capital	Venture capital		
				Bank
		Angel investors		
	Subsidy, institutional loans, etc.			
				General investors
NEW FUND-RAISING METHOD		New venture capital		
			Equity-Capital-Like-Loan (ECLL)	

(Source: "Guide for Use of Venture Capital Loan Scheme" of Japan Financial Corporation)

During several years after the business is founded (startup period), they need to obtain a substantial amount of money but have little credit from financial institutions, so they have to rely on angel investors or subsidies from the government. After a successful business expansion, these often utilize VC. But they are supposed to go public in a short period of time to meet the strong expectations from VC. This is not yet common among Japanese businesses. As illustrated in the following table, though number of domestic IPOs has seen a significant recovery over the last six years, it is still difficult for most startups and ventures to go for an IPO.

FIGURE 17 NUMBER OF INITIAL PUBLIC OFFERINGS (IPOS) FOR THE LAST 10 YEARS



(Source: Japan Venture Research)

Businesses also need to have a sufficient history of sales and profits to obtaining debt finance from banking institutions, as their business track record is one of the crucial criteria for credit screening.

Nowadays, MSMEs' access to financing is being improved in Japan, though not substantially, because of the monetary easing measures of the Bank of Japan and the new policy of FSA. Even so, Japan's financial institutions are not yet ready to actively take the risk of irrecoverable debts because the interest spread between the loan interest rate and deposit interest rates for domestic financial institutions still tends to reduce due to the negative interest rate policy, and non-performing loans will have a considerable adverse impact on the financial condition of financial institutions. Moreover, direct financing is even less accessible for MSMEs preparing for startup. In this sense, the financial environment marked little improvement for MSMEs.

As described above, the financing situation does not allow to supply sufficient MSME financing to early-stage ventures. Equity-Capital-Like-Debt-Borrowings (ECLDB) is expected to increase the capital of MSMEs and lead to an increase in lending from private financial institutions (pump-priming effect).

VC of a new type (Shinkin Capital) enables the financial institution not to rush with selling its shares in ventures as in the case of conventional VC, it is primarily designed to contribute to the local companies' development, and ultimately – to the regional economic growth. Thus, Shinkin Capital considers both the

businesses likely to go for an IPO in the near future and the early-stage businesses with a growth potential in the long term, although with the limitation of waiving the voting rights for the initial five years. Base on this financial scheme, Shinkin Capital satisfies financial needs of businesses at various stages from inception to growth, promoting the regional prosperity.

A unique feature of these financing arrangements is that businesses can obtain money through loans recognizable as capital, which they used to overcome their financial difficulties. These arrangements also allow businesses to have more financial capacity to unforeseeable events after the start-up.

R2-3-3 ARRANGING FINANCING TO EXISTING MSMES AND ENTREPRENEURS

The present situation of Equity-Capital-Like-Loan and Shinkin Capital for existing MSMEs and business startups is as follows.

1 Usage of Equity-Capital-Like-Loan

According to Japan Finance Corporation that provides Equity-Capital-Like-Loans, an increasing number of MSMEs have made the best use of such loans.

TABLE 19 JAPAN FINANCE CORPORATION (UNIT OF THE AMOUNTS: JPY 100 MILLION)

<Revitalization-type>

	2009		2010		2011		2012		2013	
	Loan operations	Amount	Loan operations	Amount	Loan operations	Amount	Loan operations	Amount	Loan operations	Amount
OPERATIONS AIMED AT SME UNIT	174	183	241	176	308	166	405	270	644	560
OPERATIONS AIMED AT MICRO BUSINESS AND INDIVIDUAL UNIT	-	-	-	-	-	-	-	-	10	1
TOTAL	174	183	241	176	308	166	405	270	654	561

<New businesses-type>

	2009		2010		2011		2012		2013	
	Loan operations	Amount	Loan operations	Amount	Loan operations	Amount	Loan operations	Amount	Loan operations	Amount
OPERATIONS AIMED AT SME UNIT	40	29	119	54	154	50	249	136	563	497
OPERATIONS AIMED AT MICRO BUSINESS AND INDIVIDUAL UNIT	-	-	-	-	-	-	-	-	101	17
TOTAL	40	29	119	54	154	50	249	136	664	514

(Sources: Press release dated May 30, 2014 of Japan Finance Corporation.)

2 Utilization of new venture capital (Shinkin Capital)

Shinkin Capital provides equity and loans to MSMEs in various fields, regardless of business scale, to vitalize regional economies. It started lending in June 2014 and made investment amounting to JPY 1,520 million [USD 13 million] to a total of 48 businesses by the end of March 2016.

TABLE 20 MAJOR BORROWERS OF THE “SHINKIN NO TSUBASA” FUND²⁴

COMPANY NAME	INDUSTRY	OVERVIEW OF BUSINESS CAPITAL OPERATIONS	No. OF EMPLOYEES	
AKUTSU KONNYAKU CO., LTD.	Manufacturing of the arum root (“konnyaku”) and related products	A food processing company using the arum root (“konnyaku”). Products are sold at supermarkets chiefly in the eastern part of Japan	JPY 10million [USD 87 thousand]	82
AGRI INNOVATORS, CO., LTD.	Manufacturing, processing and sale of farm products	A company effectively utilizing abandoned farmland, and manufactures, processes, and sells farm products while seeking to develop the “sixth sector industry”.	JPY 5 million [USD 43thousand]	Unknown
AGRI-YA CO., LTD.	Sales of fertilizers and pesticides, and whole sale of rice	A company selling fertilizers, pesticides, seeds, seedbed soil and farming materials, and purchasing brown rice chiefly in the Hokuriku region.	JPY 5 million [USD 43thousand]	5
OFFICE SUNNY CO.	Manufacturing and sales of original paper products	A business manufacturing and selling original paper products	Unknown	Unknown
ONSENDOJ O INC.	Development and management of hot bathing facilities	A company operating hot spring facilities for one-day visitors. It aims to vitalize the local economy through local communications and bathing with a particular focus on producing an original food menu and entertainment events at hot bathing facilities in collaboration with local companies and businesses	Unknown	Unknown
DORAYA, CO., LTD.	Manufacturing and sales of confection	A company manufacturing a type of Japanese confection “Dorayaki”. Its product “Fresh Dorayaki” that uses whipped cream as filling is very popular.	JPY 3million [USD 26thousand]	5

(Sources: Website of Shinkin Capital Co., Ltd.)

As shown so far, the Government of Japan, the public and private financial institutions have launched various innovative financial arrangements for smoother financing. They are expected to continue these activities in the future.

²⁴ The loan amounts of individual borrowers are unpublished.