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Alternative finance market poised for growth in Japan

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Executive Summary



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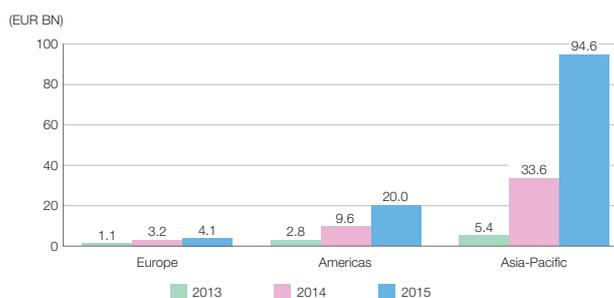
Crowdfunding and other online financing models that directly link investors with parties seeking funding are burgeoning globally. Such innovative modes of online financing are collectively called “alternative finance” in contradistinction to the traditional financial system. In Japan, alternative finance could spawn new financial markets, beginning with crowdfunded real estate investments.

Alternative finance is spreading worldwide

“Alternative finance,” a relatively recent addition to the financial lexicon, may be mistaken as a synonym for “alternative investment” such as private equity and real estate funds. Alternative finance actually refers to innovative financing models enabled by technology, directly connecting funding providers (investors) with parties seeking funding, typically through online platforms. It thus constitutes a parallel financial system that complements the traditional financial system. Popular forms of alternative finance include crowdfunding, peer-to-peer (P2P) lending and social lending. Such alternative financing models are rapidly expanding globally as shown in Exhibit 1. The UK, US and Chinese markets are growing particularly rapidly, giving rise to new financial markets distinct from conventional financial systems that predominantly revolve around financial intermediation.

In Japan today, the term “crowdfunding” tends to be strongly associated with donations to specific (e.g., local economic development) projects or prepaid purchases of new niche products to fund the products’ development or production, the latter of which is a form of so-called rewards-based crowdfunding.

Exhibit 1. Alternative finance markets’ growth



Source: NRI, based on Sustaining Momentum: The 2nd European Alternative Finance Industry Report, Cambridge Center for Alternative Finance (2016)

However, these two forms of crowdfunding account for only a tiny fraction of the overall alternative finance market and are not regulated by Japan's Financial Instruments and Exchange Act. Alternative finance mostly takes the form of public (or private-placement) offerings of stocks, bonds, investment funds (limited partnership interests) or other securities by financial product dealers via online platforms.

Alternative finance has grown, captured significant market shares

How big of a role do these alternative financing models play as an adjunct to or substitute for the traditional financial system? Exhibit 2 plots alternative finance market shares in the UK. In 2015, P2P business lending accounted for 13.9% of newly originated loans to small businesses while equity-based crowdfunding accounted for 15.6% of equity investment in development-stage ventures. In the space of a mere 3-4 years, these alternative financing models have grown enough to capture significant market shares from the traditional financial system. In the business financing space, alternative finance has grown to a scale that cannot be ignored.

Another major trend is institutional investors' growing participation in alternative finance as funders. Platforms whose funding sources include institutional investors have seen their overall market share grow from 11% in 2013 to 45% in 2015. Institutional investors accounted for 20-30% of the funding for P2P loans originated in 2015. P2P loans are becoming an attractive investment for not only individuals but institutional investors also.

Exhibit 2. Growth in alternative finance models' market shares



Note: P2P lending's 2015 market share is an estimate.
Source: NRI, based on Pushing Boundaries: The 2015 UK Alternative Finance Industry Report, Cambridge Center for Alternative Finance (2015)

NOTE

1) In the US, the Jumpstart Our Business Startups (JOBS) Act was passed in 2012; in the UK, the Financial Conduct Authority adopted regulations on equity-based crowdfunding in 2014.

2) Investment-based crowdfunding was legalized by a 2014 amendment of the Financial Instruments and Exchange Act; online sales of real estate investment interests were legalized by an amendment of the Real Estate Joint Enterprise Act slated to take effect in December 2017.

3) NRI has partnered with Kenedix, Inc., Japan's largest independent real estate asset management company, as co-owners of Bit Realty, Inc., which plans to launch a crowdfunded real estate investment service. See http://www.nri.com/global/news/2017/170810_1.aspx.

Alternative real estate finance market has promising growth prospects in Japan too

In the UK and US, the alternative finance market's rapid growth of recent years was catalyzed by legislation and regulatory rulemaking¹⁾, respectively. Even in Japan, where crowdfunding has hitherto been predominantly donation- or rewards-based, the regulatory environment is steadily becoming more permissive of monetary crowdfunding, particularly in the real estate sector²⁾.

Historically, individuals wanting to invest in real estate in their personal portfolios had only two options: (1) borrow a large sum of money to purchase condominium unit, apartment building or other property and rent it out themselves or (2) invest in publicly listed REITs, returns from which are highly correlated with equity market returns and at risk of day-to-day price volatility. Going forward, however, even retail investors will be able to conveniently incorporate real estate into their portfolios in the form of small-denomination, unlisted real estate financial products offered online as alternative investments analogous to the private funds/REITs in which institutional investors invest. Numerous platforms that use technology to provide new funding models and investment opportunities have been springing up in Japan. They have the potential to expand the alternative finance market in the real estate sector³⁾.

Making genuine alternative investment opportunities available to retail investors

Lastly, what types of changes will alternative finance bring about in Japan as it grows in prevalence?

First, parties seeking funding will no longer be restricted to conventional financing such as bank loans and equity offerings. They will gain access to a broader diversity of funding sources. As modes of financing become more diverse and flexible, latent demand for funding could materialize. Meanwhile, businesses should benefit from greater operational stability.

Funding providers, particularly retail investors, could gain access to true alternative investment opportunities for the first time. They may benefit from genuine risk diversification through financial products that focus on generating stable income streams (from, e.g., rents) instead of capital gains accruing from day-to-day price volatility and are relatively uncorrelated with publicly traded markets and other asset classes. Investors in such products of course need to be cognizant of liquidity risk, but long-term investors willing to forgo on-demand liquidity should be able to earn extra risk premia commensurate with the products' liquidity risk.

We look forward to growth in the alternative finance market and greater diversification of financing models and investment vehicles in Japan.

about NRI

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