Joint ventures

A road more travelled

In the years since the height of the financial crisis, joint ventures have become an increasingly popular way to do transactions. Some interesting trends are emerging, not least in how investors seek to protect against things going wrong.

The collapse of investor confidence, since the height of the financial crisis, has been dramatically felt in the global M&A market. So it is not surprising that many corporates – still keen to do deals, yet considerably more risk averse than of old – have looked for safer ways to complete transactions.

For many, the most attractive route to expand into new markets, diversify and search for new sources of growth or capital, has been through joint ventures rather than full-blown acquisitions. The proportion of joint ventures completed or attempted in recent years has undoubtedly grown. Getting a handle on precise numbers is tricky but we estimate that around 25% of the private M&A deals that A&O advised on in 2012 involved the acquisition of a stake (rather than 100% of the target) with that figure rising to 31% in 2013. Mergermarket’s data shows that China and India have been the top two destinations for international joint ventures – not surprisingly, since both impose strict limits on foreign investment. There has been a noticeable uptick in intra-regional deals, for instance, between Japan and South Korea, Australia and Indonesia, and France and Germany.

There are some clusters of activity between countries that share close cultural and historic ties, for example the UK and Australia and Germany and Austria. Deals emanating from developing economies remain relatively rare. Indeed, it is the U.S., UK, France, Germany and Japan that rank as the busiest locations for dealmakers looking to do joint ventures.

Emerging trends

Given this picture of growing activity, we analysed 50 joint venture deals we advised on between 2011 and 2013 to test our sense that there is no accepted formula for dealing with many of the issues that arise in negotiating these transactions. In fact our analysis shows a wide variation in approach, particularly in the mechanisms investors use to protect against deadlocks, exits and defaults.

Although the deals spanned a wide variety of sectors, retail and consumer goods was the most active, followed by the telecoms, industrial and life science sectors. The rationale for choosing the joint venture route was sometimes sector-specific but there were a number of drivers common to all sectors.

Local partner

For instance, many saw the benefit of teaming with a partner with strong local market knowledge, a known brand and an established footprint, in return for operational know-how and funding. The desire to bring together two businesses with different geographical strengths to create a global or broader regional business was also a common theme, as was the desire to realise savings and economies of scale. Restrictions in some markets on levels of direct investment also made a joint venture the only real route for transactions.

Corporate joint ventures dominated our sample, with 86% falling into this category, reflecting a broad consensus that this structure offers important benefits, including independence, permanence and limited liability. Contractual joint ventures and those done via limited and general partnerships offered some clear advantages but often posed difficult issues in terms of liability.

It was common for joint ventures in the sample to contain an obligation on both parties to fund the operation during a relatively short one- or two-year start-up period. After that, approaches diverged,
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with 36% opting to rely on third party bank debt, 30% leaving the question open or subject to a future decision by the board and 26% opting to fund via pro rata shareholder loans and/or equity. There was also a wide variety of remedies employed when one party failed to meet its pro rata funding obligations, ranging from interest charge right up to severe sanctions such as a call option on its shares at a discount to market value.

Board structures tended to reflect shareholding levels, with investors holding 20% or less of the joint venture often only having veto rights over a limited number of key decisions.

Breaking deadlocks

Some 56% of deals included non-binding mechanisms, such as mediation, escalation or negotiation, to deal with any deadlock between shareholders or among board directors. The rationale here is to seek a way to break a deadlock without resorting to a range of more radical options such as “Russian roulette”, “Texas shoot-out” or compulsory winding-up.

Similarly, dispute resolution measures in joint venture deals tend to start with a requirement for good-faith negotiations since it is essential to the success of the venture that both parties do their utmost to cooperate effectively.

A binding method of resolving disputes also needs to be included in case negotiations fail, and there is a sharp contrast here between joint ventures and other M&A transactions – with 71% of joint venture deals choosing arbitration rather than litigation to resolve disputes, compared with around half of other M&A deals.

One clear trend is for joint venture agreements to include specific anti-bribery and corruption measures, in recognition of the growing international reach of legislation such as the UK Bribery Act and the U.S. Foreign Corrupt Practices Act. In 2013, 54% of deals included such measures, compared with 45% the year before. And, interestingly, 18% of joint ventures also dealt with wider corporate responsibility issues, such as health and safety, ethical behaviour, working hours and discrimination.

All the deals included restrictions on the transfer of shares to other parties, with 58% of deals containing provisions that locked in the joint venture partners for anything between one and ten years. Although freedom to transfer after a designated period (subject to a right of first offer for the other party) was the common approach, 11% of deals contained clauses forbidding any transfer without the consent of the other party.

Many international joint venture investors have concerns that their local partner could use knowledge gained from the joint venture to set up a rival operation. For that reason it is common to find strict non-compete measures (70% of deals) as well as non-solicitation rules (58%) usually related to poaching key employees.

In over half of the deals we analysed, the governing law was that of the place where the joint venture company was incorporated. This makes sense as it obviously limits the chances of legal conflicts and difficulties. But in over 90% of joint ventures where the governing law was different to the place of incorporation, English law – widely seen as both well established and pro-commerce – was chosen to govern the joint venture.