# JOINT VENTURES BETWEEN PRIVATE EQUITY FUNDS AND SHIPPING COMPANIES –

## CURRENT STRUCTURES AND EXIT SCENARIOS

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### 1. PRIVATE EQUITY ENTERED THE SHIPPING INDUSTRY

Private equity funds have been around in the shipping industry for a couple of years now. Attracted by vessel values trading at (historically) low levels following the outbreak of the shipping crisis in 2008 and fostered by banks that have traditionally lent money to finance the acquisition of vessels pulling out of ship finance, private equity funds have commonly teamed up with shipping companies to form joint ventures to exploit investment opportunities.

The fundamental principle of these co-operations is as simple as that: shipping companies struggling to obtain finance for vessel acquisitions were welcoming capital provided by private equity funds which, in turn, benefitted from the shipping expertise of their partners both in terms of identifying attractive opportunities by leveraging on the shipping companies' network and their capability to efficiently manage the vessel investments.

Against this background, it does not come as a surprise that joint venture co-operations seem to be the most favoured type of investment private equity made into shipping. Given the short- and medium-term investment horizon of private equity, these joint venture co-operations were typically designed for a period of three to seven years and the time is about to come where private equity funds will actively seek to manage their exit.

### 2. FORMS OF CO-OPERATIONS

While co-operations between private equity funds and shipping companies could be set up as mere contractual joint ventures, the vast majority of the joint ventures are formed on the basis of a mutual corporate vehicle. A purely contractual joint venture means that parties do not jointly own a corporate entity, but would only be bound by contractual arrangements. Such an approach would be more typical where the investment is made solely for the account of the private equity fund and the shipping company is only offering its market expertise and management services for a fee without contributing any funds for the vessel acquisition. More commonly, the parties agree to a corporate joint venture, meaning they are setting up a joint holding company which will then wholly own several single purpose companies, each holding a vessel. Such holding company will typically be majority owned by the private equity fund providing for the majority of the funding and standard equity ratios between private equity fund and shipping company are approximately 90%:10% or 80%:20%, but in some cases parties also agree to equal funding. Interestingly, although the private equity fund typically owns the majority of the equity and the voting rights, it does not necessarily control the joint venture. Quite typically, parties agree to joint control, because the private equity fund acknowledges that the shipping know-how rests with the shipping company and agrees to implement corporate governance ensuring that key commercial decisions cannot be passed against the vote of the shipping company. Technically, such joint control is ensured through unanimity requirements in the shareholders' meeting and equal representation of both partners in the board. Domicile for the holding company (and the

vessel-holding SPVs) will mostly follow tax considerations. Accordingly, Marshall Islands or Luxembourg are obvious choices. Joint ventures domiciled in other jurisdiction, such as, for example, Germany, will need to pay close attention that the corporate set-up of the joint venture does not jeopardise tonnage tax benefits in the respective flag jurisdiction.

Some further, less common forms of joint ventures contemplate that the shipping company would contribute part of its own vessels or new-build orders into the joint venture. Mostly, the goal in those cases would be to achieve (together with the new acquisitions of the joint venture) critical mass to pursue an IPO or other forms of disposal that the shipping company could not pursue on its own. Other joint venture co-operations are more limited in scope and are established for the sole purpose of acquiring certain pre-agreed vessels (mostly new-build orders) and are not intended to grow any further.

## 3. INVESTMENT TARGETS AND EXCLUSIVITY

The scope of investment targets varies: some joint ventures are targeting new-build vessels only, while others are solely focusing on second-hand tonnage. In any event, the scope is mostly restricted to certain types of vessels (such as container ships or bulkers) and a specific size range. This follows the fact that the private equity fund has typically chosen its shipping partner for its expertise in a certain segment.

The specifications of the vessels that the partners intend to acquire through the joint venture will need to be carefully defined. The reason for this is that commonly the target vessel criteria are also authoritative for the scope of the right of first refusal and exclusivity which the joint venture enjoys. The partners may not invest in any vessels that meet the defined target criteria, unless they have first offered such opportunity to the joint venture, and they are contractually prohibited from establishing co-operations with other potential partners within the realm of the target vessels. It is thus crucial to appropriately tailor the scope of the intended co-operation to ensure that it does not conflict with other existing co-operations or constrains the possibility to team up with other partners for similar investments.

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Private equity funds typically request certain exceptions to the exclusivity. Classic examples of investment types that are typically exempt from exclusivity (even if they indirectly include target vessels) are loan portfolio transactions, investments in securities that are secured by target vessels, investments in (listed) shipping companies or their debt or opportunities presented by the shipping company that the private equity fund is already independently aware of.

## 4. COMMERCIAL AGREEMENTS

In most of the co-operations, the shipping company undertakes to perform the technical and commercial management as well as portfolio management services towards the private equity fund and the joint venture vehicle. Issues to be considered in such circumstances comprise, among others, the following aspects.

### 4.1 Equal treatment

Normally, the shipping company is managing other vessels beyond the vessels of the joint venture and in many cases this may also include vessels actually owned by the shipping company. It is therefore important for the private equity fund to safeguard that the vessels belonging to the joint venture are treated at least equally to all other vessels under management of the shipping company. While such principle should be agreeable to the shipping company in general, details of how this can be controlled in practice require further thoughts having regard to the individual case and there is no one-fits-all solution.

### 4.2 Related party disputes

As the service agreements are commonly entered into by the joint venture vehicle and the shipping company, any legal measures adverse to the ship manager will need to be exercised by the joint venture vehicle. The private equity fund will be interested in excluding any blocking power the shipping company may have in the internal governance process at the joint venture level and regularly related party disputes are subject to lengthy discussions between the partners. Not least, this is because, for the shipping company, performance of the services to and the equity participation in the joint venture are intrinsically linked with each other. The latter connection may be reflected in a put option in favour of the shipping company and a corresponding call option by the private equity fund in respect of the shipping company's participation in the event the management services are terminated.

## 5. DISTRIBUTIONS

While distributions are of a predominantly commercial nature, specific attention should be paid to ensure that the commercial agreement is properly translated into the joint venture documentation. Having regard to its internal return requirements, private

equity funds may seek to agree on a (upfront) preference within the distribution waterfall up until it has reached a certain IRR threshold. Reversely, to incentivise the ship and portfolio manager, disproportional distributions for the benefit of the shipping company may be agreed that gradually increase at certain (higher) IRR levels.

Depending on the private equity fund's internal requirements, it may be necessary to provide for a right of the private equity fund to require the sale of a vessel to generate distributable cash in case of a liquidity event that forces the private equity fund to repay funds to its investors on short notice.

## 6. EXIT

While private equity typically seeks to prevent a scenario where the shipping company may pull out of the joint venture for an initial period of time (so-called lock-in period), evidently, exit scenarios are of significant importance to private equity given its short- and medium-term investment horizon. The following exit scenarios should therefore typically be discussed and considered in the context of the co-operation.

### 6.1 Trade Sale

In contrast to the lock-in period applicable to the shipping company, the private equity fund will likely ask for free transferability in respect of its participation and the possibility to require the shipping company to sell its participation alongside the private equity fund (so-called drag-along right). Both are designed to ensure that the private equity fund can exit the joint venture at its free discretion by forcing a trade sale of the fleet or the joint venture itself. At the same time, the drag-along right may contrast with the shipping company's interest in preventing a forced sale if it believes that such sale would destroy values. Contrary to the drag-along right, the shipping company will request a tag-along right, i.e. the right to request the private equity investor to co-sell the shipping company's stake, also, in the event of its exit.

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### 6.2 IPO

While it remains to be seen how many of the joint ventures established between private equity and shipping companies will actually achieve a critical mass including building up a sufficient independent business case to appeal to public market investors, many of the joint venture co-operations have contemplated such an exit scenario either in a generic way or more profoundly in the joint venture documentation. The devil lies in the detail here and, depending on the parties' willingness to provide for a set of more comprehensive regulations, the following aspects may be worth addressing: (i) unilateral right of the private equity fund to force an IPO; (ii) registration rights (demand or piggyback rights) and guidelines on their exercise; and (iii) treatment of a management incentive in an IPO (including related valuation issues to calculate the amount of the management incentive).

### 6.3 Private Placement

As an alternative to an IPO, the private equity fund may pursue a private placement to sell down its stake in the joint venture by bringing in additional financial investors. As such, financial investors typically sign up for small equity tickets; however, the private equity fund would generally retain a controlling stake in the joint venture. Typically, such new financial investors would be expected to take on a passive role with limited control rights, and the initial joint venture partners would seek to limit any impact on the underlying joint venture documentation or operations of the business.

### 6.4 Securitisation

Securitisation is not the obvious and clearly not a "mainstream" exit strategy for joint ventures established between private equity and shipping companies, but it may provide opportunities for the joint venture partners that are worth considering in each individual case. Generally, securitisations of shipping assets are still rare in the market. While there have recently been a few securitisations of shipping loan portfolios originated by shipping banks, a securitisation exit in the context of shipping joint ventures would, rather, have to be structured as a kind of "corporate" securitisation involving the sale of the vessels or the vessel-owning entities to a special purpose securitisation vehicle which refinances the acquisition of the assets by issuing debt and/or equity capital instruments. In our experience, such transactions are innovative and complex in that they require "bespoke" solutions to be tailored to each individual case. Particular opportunities may arise if the securitisation exit can be structured such that the instruments have the benefit of a credit rating, thereby broadening the investor base and attracting new investors that might otherwise not be willing or able to invest in shipping assets.