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Strategic Cooperations Between Private Equity Sponsors And Corporate Investors: Key Structuring Considerations And Deal Terms for JV Arrangements

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Summary

- **To ensure the alignment of a PE sponsor's financial objectives over a fixed period with a strategic investor's long term objectives, the structure and key terms of such cooperation should be carefully planned.**
- **Careful planning of the JV's governance structure and its control over portfolio companies is required.**
- **In addition to the structuring considerations and legal forms there are several commercial and legal terms that the parties will want to carefully consider.**

Private equity (PE) sponsors have increasingly been entering into joint venture (JV) arrangements with strategic investors by offering a customized alternative to traditional PE funds.

Such JV cooperation is gaining popularity because it provides unique opportunities to PE sponsors and strategic investors. The arrangement allows for customized structuring and economic terms, as well as other tailor-made terms based on a strategic investor's special needs. A PE sponsor, in turn, gains access to capital, attractive industry expertise and synergies, and potential exit solutions for portfolio companies.

Tailor-made JV arrangements are often extensively negotiated and involve sizeable investments to justify the time, efforts and costs required. To ensure the alignment of a PE sponsor's financial objectives over a fixed period with a strategic investor's long term objectives, the structure and key terms of such cooperation should be carefully planned.

Structuring Considerations

Developing a structure that addresses both parties' distinct needs can be challenging because of the number of factors to be considered.

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Tax Considerations. For both parties, a structure that achieves tax efficiencies to the maximum extent possible is key. A PE sponsor will look for a structure that addresses the tax needs of its underlying investors (in the case of a PE sponsor that invests side by side with the strategic investor), as well as tax considerations related to its internal carry structure. A strategic investor will need to consider the applicability of tax treaties, potential tax leakage and the types of tax and financial information it requires in order to ensure compliance with relevant tax rules, among others.

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Consolidation Considerations. To avoid undesirable implications to its existing operations and/or the operations of the JV's portfolio companies, and to reduce regulatory filings that may be required in connection with the JV's investment activities, a strategic investor often considers it critical to design a structure that would not trigger accounting or antitrust consolidation. Careful planning of the JV's governance structure and its control over portfolio companies is required to ensure that the JV's portfolio companies will not be consolidated with the strategic investor's existing operations for antitrust or accounting reasons.

Other Considerations. Furthermore, the parties need to consider other factors such as the structure's complexity and maintenance costs, whether to comingle the capital of the PE sponsor and the strategic investor, ease of deal execution, how much influence the strategic investor desires to retain over the JV and its investment activities, and how to ensure maximum alignment and accountability between the parties in respect of the JV's operations.

Structuring Options

Depending on the business objectives of the parties, such JV collaborations can take different legal forms. They can, for example, be formed as fund vehicles or as purely contractual arrangements. There are three main legal forms, each with its own merits and potential drawbacks for both parties.

Separately Managed Account (SMA). This may involve the establishment of a legal entity (e.g., a limited partnership) that is mostly or entirely funded by a strategic investor but otherwise controlled by the PE sponsor. Alternatively, no legal entity is formed. Instead, the strategic investor establishes a bank account under one of its own existing entities but gives the PE sponsor control of the account, as well as of any investment decisions. The SMA structure generally does not comingle the strategic investor's capital with the money of any other party, including that of the PE sponsor. Under this structure, the PE sponsor is generally vested with investment discretion and therefore has sole or primary control over the strategic investor's capital.

Joint Venture Fund (JV Fund). Under the JV Fund structure, a legal entity (e.g., a limited partnership or an LLC) can be formed in which funding by one or more PE funds managed by the PE sponsor and the capital provided by the strategic investor do comingle. This option allows for flexibility in structuring the rights and obligations of the JV parties, as well as in structuring underlying investments of the JV Fund. The PE sponsor's own managed fund(s) will invest side by side with the strategic investor, and the strategic investor is likely to have some influence on most or all aspects of the JV Fund subject to accounting, antitrust, tax and other considerations applicable to the strategic investor.

Investment Platform Agreement (IPA). Under this structure, no legal entity is formed. Instead, the JV parties enter into contractual arrangements to: (i) provide investment capital to fund portfolio investments during a fixed period subject to a cap; (ii) pay for certain types of expenses incurred by each other in relation to the operations of the IPA and each portfolio investment consummated pursuant to the IPA; and (iii) provide each other's internal figures related to the performance of each portfolio investment, in order to aggregate the performances of such portfolio investments and calculate the amount of management fees and carried interest that may be owed to (or in the case of overpayment of carried interest, should be repaid by) the PE sponsor.

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In practice, the SMA and JV Fund structures are equally popular, while the IPA structure is less favored due to the complexities involved in terms of structuring and execution. Various tweaks may be made to a selected legal form based on the structuring considerations discussed above.

Key Deal Terms

In addition to the structuring considerations and legal forms discussed above, there are several commercial and legal terms that the parties will want to carefully consider, including the key points below.

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Exclusivity. Strategic investors typically enter into such JV cooperation with the goal of gaining access to investment opportunities in specific geographical areas, industries and/or sectors that are of great strategic importance to them. Therefore, they expect a certain degree of exclusivity over such investment opportunities. The JV arrangements will need to address such needs and clearly define the scope and duration of exclusivity (if any), each party's ability to pursue certain investment opportunities outside the JV arrangements and the internal procedures required to ensure compliance therewith. PE sponsors should also carefully review existing fund documents to ensure that any agreement over exclusivity is permitted thereunder.

Exit Options. Given that PE sponsors typically operate within a fixed time frame, strategic investors expect to have a clear understanding of exit options concerning the JV's investments. A material business negotiation matter is thus around a strategic investor's priority rights to acquire the assets of the JV, which could include a package of call rights, rights of first offers and/or rights of first refusal for some or all of the portfolio companies. Timing and pricing of such priority rights are usually heavily negotiated.

Economics. It is common for a PE sponsor to collect some level of fees and/or carried interest from the deals executed by the JV. The profit sharing and fee structure of such JV arrangements may, however, be different from that of a traditional PE fund and depend on the amount of resources allocated by each party to the JV. The management fees are sometimes based on invested capital or net asset value rather than on committed capital both during and following the investment period. Also, the carried interest split is usually negotiated as a package deal taking into account any special rights or benefits that may be granted to a strategic investor.

Governance. Depending on the legal structure of a particular JV, the governance structure and decision making process of such cooperation arrangements may vary. As noted above, the level of involvement and/or control a strategic investor may desire often depends on the accounting and antitrust analysis. In most situations, strategic investors will want to have some say in the investment process and sit on the investment committee. At one end of the spectrum, such JV cooperation may take the form of a 50:50 JV Fund structure, under which the strategic investor not only commits at least 50% of the capital as a limited partner but also owns up to 50% of the equity interest in the general partner (GP) of the JV Fund. Under such a structure, the strategic investor naturally plays a more active role compared to a passive investor in a traditional PE fund. At the other end of the spectrum, the strategic investor may decide not to be part of the GP and instead only seeks to obtain certain consent and/or monitoring rights, more like a passive investor in a traditional PE fund. In other cases, a strategic investor may want to own a small minority equity interest in the GP, have representation on the board of the GP and seek a veto right over major decisions affecting the JV and its investments. Regardless of the legal structure of the JV, the key consideration for the parties is to design a governance structure that would allow the JV to move quickly yet prudently in increasingly competitive markets.

Expenses. The JV parties will also need to consider how expenses will be shared depending on whether the PE sponsor will co-invest alongside the strategic investor. Sometimes the strategic investor or both parties will need to provide start-up capital due to a lack of sufficient cash flow at the outset. If so, the JV documents should specify the details concerning the payment of the start-up capital and the timing of repayment.

Warehoused Deals. Sometimes, prior to the launch of a JV, one or more investments may be acquired by the PE sponsor or an affiliate thereof in anticipation of the closing of the JV. Under such circumstances, the parties will need to discuss the terms under which such warehoused deals may be transferred to the JV following the closing. Depending on how the investments were originally financed, there could be additional complexities in the true-up payment mechanism.

Separation/Termination. Parties entering into a JV cooperation expect the partnership to be successful and long-lasting. However, it would be prudent to put in place separation mechanisms to ensure that the partnership can be properly terminated should it be necessary. Rights to terminate or suspend the investment period, to remove the PE sponsor and/or to terminate the JV are typically discussed at length in such arrangements. It would be to both parties' benefit for the relevant provisions to clearly specify the circumstances under which such removal or termination rights can be exercised, and the related consequences and remedies.

The above discussion focuses on JV arrangements that do not involve fundraising from third-party investors. If third-party investors are expected to be solicited for investing alongside the JV parties, there will be additional complexities as to the structuring and deal terms discussed above (e.g., management fee split/carried interest split between the parties) as well as additional regulatory and tax implications.

As strategic investors continue to seek ways to broaden and deepen their cooperation with PE sponsors in various sectors, strategies and/or geographical areas, it is expected that there will be more JVs being formed in the coming years. Ultimately, the success of such partnerships will depend on the strength of the relationships, shared vision and trust developed between the JV parties. Carefully navigating the structure, investment program, governance, economics and other key terms of such arrangements at the outset can help create a constructive, long-lasting relationship.

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