The Pros and Cons of Using Joint Ventures as a Tool to Mitigate Political Risks in Developing Countries

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Abstract
As part of their political risk management strategy, multinational corporations (MNCs) can use joint ventures as a tool to reduce their exposure to political risks in international activities. The aim of this article is to present the main benefits for MNCs in using joint ventures with a local partner to mitigate political risks in developing countries and to put forward three risks that MNCs have to consider when choosing the local partner (the risk of opportunistic expropriation, the risk associated with transferring of intellectual property rights and reputational risk).

Keywords: political risk, multinational corporations, risk management, joint ventures

JEL Classifications: F23, G32, H13

1. Introduction

According to a report of UNCTAD on world investments in 2016, global foreign direct investment (FDI) flows increased by 38% in 2015 compared to 2014, reaching USD 1.76 trillion, their highest level since the global economic and financial crisis of 2008–2009. FDI inflows in developing economies increased by 9%, while developing economies continued to comprise half of the top 10 host economies for FDI flows (UNCTAD, 2016). After this strong rise in 2015, global FDI flows decreased in 2016 by 2%, in the context of weak economic growth and significant policy risks, as perceived by multinational corporations (MNCs). Flows

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to developing economies were especially hit, with a decline of 14% in 2016 compared to 2015 (UNCTAD, 2017).

In their international activities, MNCs face various risks. Political risk is one of them. Molano (2008: 18) defines political risk as “the broad spectrum of actions in the political and social environment which can influence a transnational actor’s property rights, income or market”. MNCs can experience significant damage or loss of their entire investments as a result of political risks like expropriation or nationalisation, transfer and convertibility restrictions, breach of contracts, acts of terrorism, domestic political violence (e.g. the hostile actions of national forces, revolutions, civil war, and insurrection) or other adverse regulatory changes and/or negative government action. Political risk is more relevant to the companies operating in emerging markets (Bremmer and Keat, 2009; McKellar, 2010). In a report of the Multilateral Investment Guarantee Agency (MIGA) on world investments and political risk in 2013, MNCs operating in developing countries ranked political risk as their second highest concern over the following three years, immediately after macroeconomic instability (MIGA, 2014).

In order to mitigate political risks, MNCs’ political risk management strategy includes a variety of tools. One of them is the use of a joint venture with a local partner. According to MIGA’s 2013 report, 46% of MNCs were using a joint venture or an alliance with a local company to mitigate political risks when investing in developing countries (MIGA, 2014). Moreover, in the case of breach of contract risk, 24% of MNCs considered a joint venture with a local enterprise to be the most effective risk mitigation tool, more than any other tool.

2. Benefits of setting up a joint venture with a local partner

For MNCs, a local partner in a joint venture can bring its knowledge of the local business environment and smooth the relations with the political stakeholders by using its network connections (Duanmu, 2011; Schindler and Schjelderup, 2012; Du, Lu and Tao, 2012; García-Canal and Sánchez-Lorda, 2012; StrategicRISK, 2015; Stephens, 2015).

A local partner with strong ties with the local or central government can benefit of favourable treatment from the government institutions (Jiang, Chu and Pan, 2011) and reduce the political risk of MNCs (Howell, 2008). Host governments are less willing to come with negative actions against the joint venture because those measures could possibly impact both the local and the foreign partner (Bremmer and Keat, 2009). In countries with high political risk and instability, MNCs prefer to use joint ventures rather than wholly owned subsidiaries as a market entry method in order to reduce their risks (Slangen and van Tulder, 2009; Morschett, Schramm-Klein and Swoboda, 2010; López-Duarte and Vidal-Suárez, 2012;

García-Canal and Sánchez-Lorda, 2012). Finally, joint ventures with local investors minimise the risk of expropriation (Hain, 2011; García-Canal and Sánchez-Lorda, 2012).

3. Forced joint ventures

Entering a joint venture with a local investor is not always a free choice of MNCs, but may come following the pressure of the host government, thus making the joint venture a forced process. For instance, a restriction which is often imposed on FDI in the natural resources sector is mandatory joint ownership with local firms (Ghebrihiwet and Motchenkova, 2017). Konrad and Lommerud (2001) and West (2008) argue that it may be in the interest of the MNCs to partly ignore their financial motivation and share their ownership with local partners if this reduces the expropriation risk. Even in the case of "forced joint ventures", MNCs recognise that local partners understand the local environment better and can advise on the home political economy (Luiz and Stephan, 2012).

Repsol YPF's partnership with Petersen Energía can be easily considered a "forced joint venture". The former president of Argentina, Néstor Kirchner, designed the Eskenazi family's entry into YPF (Webber, 2012). Néstor Kirchner had a close friendship with Enrique Eskenazi, which ensured the latter direct contact with to the president. For Néstor Kirchner it was the solution to bring an Argentinean partner for Repsol and the indigenisation of the company. Petersen Energía acquired 14.9% stake in December 2007 and exercised the option to purchase an additional 10.1% in 2011. In total, Petersen Energía acquired 25.5% stake in a "highly leveraged USD 3.5 billion transaction" (Webber and Rathbone, 2012). Because Petersen Energía had little cash, Repsol YPF and a group of banks lent the money for the transaction. Moreover, Repsol YPF agreed to pay out 90% of its profits in dividends to allow the Eskenazi family to repay the loans, a very advantageous scheme for their partner.

Repsol YPF is not a unique case of a forced joint venture. MNCs operating in Kazahstan have used the same strategy. The consortium of ExxonMobil, Shell, Total France, Eni, Conoco and Inpex resolved a dispute over Kazakhstan's vast Kashagan oil field by agreeing to cede a stake in the project to the national oil company, KazMunaiGaz, in January 2008 (Pfeifer and Gorst, 2011). As a result, the share of KazMunaiGaz in the project increased from 8.33% to 16.8%, at the expense of the other consortium members. As experts already predicted, another foreign project in Kazakhstan had the same fate. In December 2011, the foreign companies operating the giant Karachaganak oil and gas field since the mid-1990s (BG Group, ENI, Chevron and Lukoil) signed a USD 3 billion agreement with the government to transfer a stake of 10% in the project to KazMunaiGaz. The

foreign companies each had to dilute their shares in the project to make room for the state-owned company.

4. Limitations

Joint ventures with local partners can help reduce risk exposure, but the success of this strategy depends fully on choosing the right partner (Bremmer and Keat, 2009). Lloyd's warned in 2009 (Lloyd's, 2009) about "false friends", local partners of MNCs, which are not exempted from the arbitrary behaviour of governments in countries with higher risk. Some of those higher political risks include the risk of opportunistic expropriation by the host government, the risk associated with transferring of intellectual property rights and reputational risk.

4.1 The risk of opportunistic expropriation

Although the risk of opportunistic expropriation is likely to be less important today than in the past because of increased legal protection and better knowledge of companies' reputation (Aguir and Misra, 2017), the risk for a MNC being expropriated by its local partner, with the help of the host authorities, still exists. This was the case of Repsol.

What seemed to be a very good risk mitigation strategy for Repsol YPF, it turned out in the end to fall under the limitations of entering a joint venture. Having a partner aligned with the country's political regime makes it vulnerable when the regime falls (Sharma, 2012). It is true that the former president Néstor Kirchner had himself brought Petersen Energía as a partner into Repsol, but the Argentinean president at that time, Cristina Fernández de Kirchner, proved ready to go against the interests of their former "friends". Following the nationalisation of YPF on 16 April 2012 by the Argentinean government, Petersen Energía lost their entire stake of 25.46% in YPF after they defaulted on loans used to buy it.

4.2 The risk associated with transferring of intellectual property rights

The local government can require a MNC to meet difficult requirements that put the foreign partner at a disadvantage, such as the transfer of intellectual property rights to the local partner. Javorcik and Wei (2009) find that foreign investors with sophisticated technology may experience technological leaks or abuse in joint ventures and are less interested in forming a joint venture.

4.3 Reputational risk

The local partner risks contaminating the image of the foreign company when its involvement in dubious business becomes public, for instance in the situation

where children are identified as the labour force, corruption etc. (Bremmer and Keat, 2009).

McKellar (2010) highlights that a state-owned company could actually be controlled by political figures involved in criminal activities or violating human rights. A due diligence process can detect such risks, saving the MNC from damaging reputation. Carrying out a due diligence is the unanimous recommendation that researchers and experts give to MNCs in such cases. For example, in Brazil, the set-up of joint ventures is often required for large and complex projects. At the same time, the country is well-known for the corrupt environment, with 84% of companies operating in Brazil saying bribery and corruption are common practices in the country (Ernst & Young, 2012). It is therefore understandable that any joint venture is exposed to the corruption risk of the local partner. Under these circumstances, a due diligence process on future business partners is essential.

5. Conclusions

The use of joint ventures with a local partner in order to mitigate political risks has many benefits which can be observed not only in the case of the voluntary set-up of joint ventures, but also in the so-called forced joint ventures. Joint ventures with local partners, either voluntary or forced, can help reduce political risk exposure; however the success of this strategy depends fully on choosing the right partner. In evaluating the limitations of using joint ventures as a political risk mitigation technique, MNCs should assess the risk of opportunistic expropriation by the host government, the risk associated with the transferring of intellectual property rights and reputational risk. A proper due diligence of the local partner can help reducing those risks.

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