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M&A Looking Ahead to 2024

Trends in Private Equity, Insurance Due Diligence, and M&A Insurance

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Private Equity Market Update

Todd Dorsey, Luke Parsons, Brian O'Regan and Jhana Kind

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1.1 The Turbulent Deal Landscape Continues in 2023, but the Future Appears Brighter

As predicted in last year's *Looking Ahead Guide*, 2023 has proven to be a tough year for dealmakers. Through the first half of 2023, the themes of 2022 (reduced deal volume and more competition for private equity deals) continued to cause the deal landscape to be exceedingly tough. According to Bain & Company's *Private Equity Midyear Report 2023*, "uncertainty is the enemy of dealmaking, and uncertainty has been swirling through global markets in abundance." Geopolitical uncertainty, continued rising interest rates, and a banking crisis have all played roles in decreasing deal flow. In fact, dealmaking has declined in four of the last six quarters. Since peaking in Q4 2021, quarterly volumes are now down 24% by deal count and 49.2% by deal value (according to PitchBook's Q2 2023 US PE Breakdown) and exit activity has fallen 75% from peak (2021) to trough on a quarterly basis, showing no signs of improving over the next several quarters.

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Even in this tougher market, private equity funds are still managing to put capital to work by keeping deal sizes small or finding alternative sources of capital to finance the transactions.

Take-privates (43 announced as of July 2023) and carveouts (7.8% of US deals in Q2) are also becoming more prevalent as the leveraged buyout (LBO) market struggles with uncertainty.

Many private equity firms are looking at a condensed time horizon on the sell side, according to PitchBook. Its analyst note, *PE Exit Timelines and the Impending Maturity Wall*, pointed out there are many US-based private equity funds approaching the maturation stage of their funds. But these funds may not want to divest what could be solid assets, given the deal marketplace is so tough and valuations are down as much as they are. According to the Bain & Company report, this is causing many private equity firms to reset value creation plans at the portfolio company level, getting back to the basics of EBITDA margin **and** revenue growth.

Looking forward to Q4 2023 and into 2024, we believe while the deal landscape may continue to evolve and new structures develop, deal flow will increase as compared to 1H 2023.

According to S&P Global Market Intelligence, global dry powder has swelled to $2.49 trillion. With three-fourths of that dry powder reserved for private equity buyout strategies raised in the last three years, it may seem to deal professionals like there is ample time to deploy capital. However, both fund managers and investors will likely feel the need to put money to work in 2024.

The Importance of Due Diligence and Optimizing Value for Portfolio Companies

What does this macro backdrop mean for the private equity insurance advisor in Q4 2023 and into 2024? Simply put, insurance due diligence (including post-close diligence) will continue to gain steam as deal teams and operating professionals seek ways to improve and maximize EBITDA efficiencies and mitigate risk to their investment assets. Insurance and risk management due diligence often takes a backseat to operational, legal, financial, or accounting diligence. But, if executed poorly, acquirers and investors alike may leave themselves exposed to increased risks that could negatively impact EBITDA in the short term and diminish the long-term value of the asset. Including an expert insurance advisor on the due diligence team will help companies avoid these risky land mines, protect the investment in the short- and long-term, and ensure a cleaner exit.

In addition, the current backdrop signals three things:

1. Competition will remain stiff for US-based deals at the lower and core ends of the middle market.
2. Increased scrutiny during all facets of due diligence will continue to be prevalent because of the tougher exit environment. Having an expert insurance advisor that specializes in private equity is critical.
3. As portfolio companies and their PE owners continue to increase focus and scrutiny on improving value creation at the company level, incrementally improving the companies' earnings EBITDA will be critical.

While not the top priority on a deal team's radar, insurance, employee benefits, and general risk management concerns are becoming more of a priority for private equity deal professionals. Having an expert team of insurance advisors will help deal teams act with more speed and certainty regarding the key protector and mitigator of EBITDA risk for companies: insurance.

Insurance Due Diligence for Private Equity and M&A >>

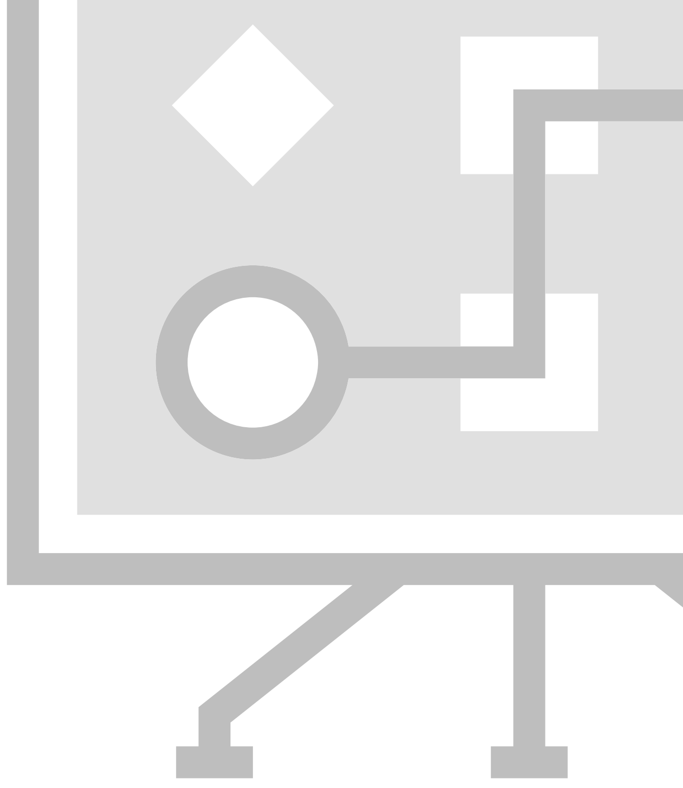
Get insight into the state of the M&A and private equity market and why insurance due diligence is more important than ever.

2.0

Private Equity Top Trends

As deal flow picks up, several trends are emerging in the middle market private equity deal landscape. We'll look at some of these trends and analyze how they affect risk management.

2.1 Trend #1: Focus on Value Creation Leads to Insurance and Employee Benefits Program Optimization Strategies



As deal flow has struggled over the last several quarters, private equity operating professionals have been taking a harder look under the hoods of portfolio companies to focus on value-creation strategies. Throughout the strong economy of historic deal volume and value (2019–2021), Bain & Company mentions in its *Private Equity Midyear Report 2023* that much of the value creation for portfolio companies focused on multiple expansion and revenue growth versus margin improvement.

> Throughout 2023 and we believe into 2024, operating professionals will focus more on EBITDA margin improvement versus solely top-line growth.

As portfolio companies begin evaluating margin improvement opportunities, we believe there will be continued renewed focus on reviewing insurance and risk management programs as well as employee benefit programs to ensure they are optimizing efficiencies and mitigating, transferring, or accepting risk where necessary.

This is because the cost of employee benefits is typically the single greatest cost a company will have outside of payroll. A broker who specializes in the private equity space knows the levers that can be pulled to improve the overall program to optimize and improve EBITDA margin.

2.2 Trend #2: Portfolio Programs are Gaining Steam (Again), but Include Faults

As we predicted in last year's *Looking Ahead Guide*, portfolio programs are continuing to gain steam. In our opinion, this trend is an offset of our Trend #1 because private equity professionals are looking for ways to gain additional value out of their portfolios. As a result, it may seem like a great idea to pool all the portfolio companies' exposures together and create a "portfolio program" that provides coverage for all property, casualty, and management liability risks throughout the entire portfolio. However, given every portfolio company and every transaction is different, with their own nuances, we generally find portfolio programs do not work.

To be clear: We believe portfolio programs do not work because the short-term increase in margin and value creation is typically not worth the exorbitant work to set up the program. They simply create more inefficiencies.

The only time in which a portfolio-wide program may work in the short term is on the management liability side of the equation.

Advantages and Disadvantages of a Portfolio Program

Advantages

- Pooled exposures/law of large numbers throughout the entire portfolio
- Seamless integration and rolling into and out of the portfolio
- Economies of scale for total cost of risk

Disadvantages

- No guarantee the insurers will accept new companies onto the program
- Stricter underwriting guidelines than others that may be commercially available with similar coverage and cost
- Claims in one company negatively impact rates for the entire program
- Time commitment for each portfolio company, private equity firm, and broker

If your firm is interested in portfolio programs, we believe a far better approach is to simply align all effective dates for a firm's portfolio together and approach the marketplace with the package of individual companies. This achieves many of the same advantages while removing the disadvantages.

2.3 Trend #3: Deal Structure Will Impact Insurance and Benefits Strategy

With the LBO market facing uncertainty, private equity firms are looking to alternative deal structures to get deals across the finish line in 2023. Add-on acquisitions, take-privates, corporate carveouts/divestitures, and growth equity deals are becoming more prevalent in today's deal landscape. Traditional stock or asset deals with less debt are also increasing. Each of these transaction structures involves a different skill set in terms of insurance and employee benefits due diligence as well as post-acquisition brokerage implementation strategy.

For example, an asset transaction requires an entirely new property, casualty, and management liability program to be implemented at close.

A take-private transaction, on the other hand, involves significant negotiation of the public company D&O tail and go-forward management liability strategy.

A carveout also requires a new insurance program to be implemented at close and also has significant implications for employee benefits and the negotiation of a transition services agreement (TSA) to ensure timelines and action items are realistic. Although we expect the deal landscape for LBOs to improve in Q4 2023 and throughout 2024, the insurance strategy around a transaction is critical to getting deals done efficiently.

Middle-market private equity or growth equity transactions have specific implications on risk management and insurance programs pre-close, at close, and post-close.

Check out our three-part series on transactional structures.

Transaction Structures and Insurance

Part 1: Asset vs. Stock Transactions >>

Part 2: Majority vs. Minority Transactions >>

Part 3: Mergers, Rollups, and Carve-Outs >>

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2.4 Trend #4:
The RWI Market Is More Competitive Than Ever

The representations and warranties (RWI) marketplace has seen a resurgence of competition in 2023 that we expect will continue throughout 2024 as deal flow begins to gain steam again. With deal flow at record lows, pricing and retentions have all decreased significantly over the last 12 months. In the historic Q4 2021, a $100 million enterprise value transaction may have received one to two RWI quotes from the broad marketplace, and that was after calling in favors.

In Q3 2023, a $50 million transaction will confidently receive more than 20 RWI quotes. Private equity firms can expect low rates in Q4 2023 and into Q1 2024, decreased retentions for the first 12 months, and broadened terms and conditions. This competitive landscape may shift slightly throughout 2024 as deal flow increases, but we expect this landscape to remain steady due to an increased supply of capital as well as new entrants in the market.

3.0

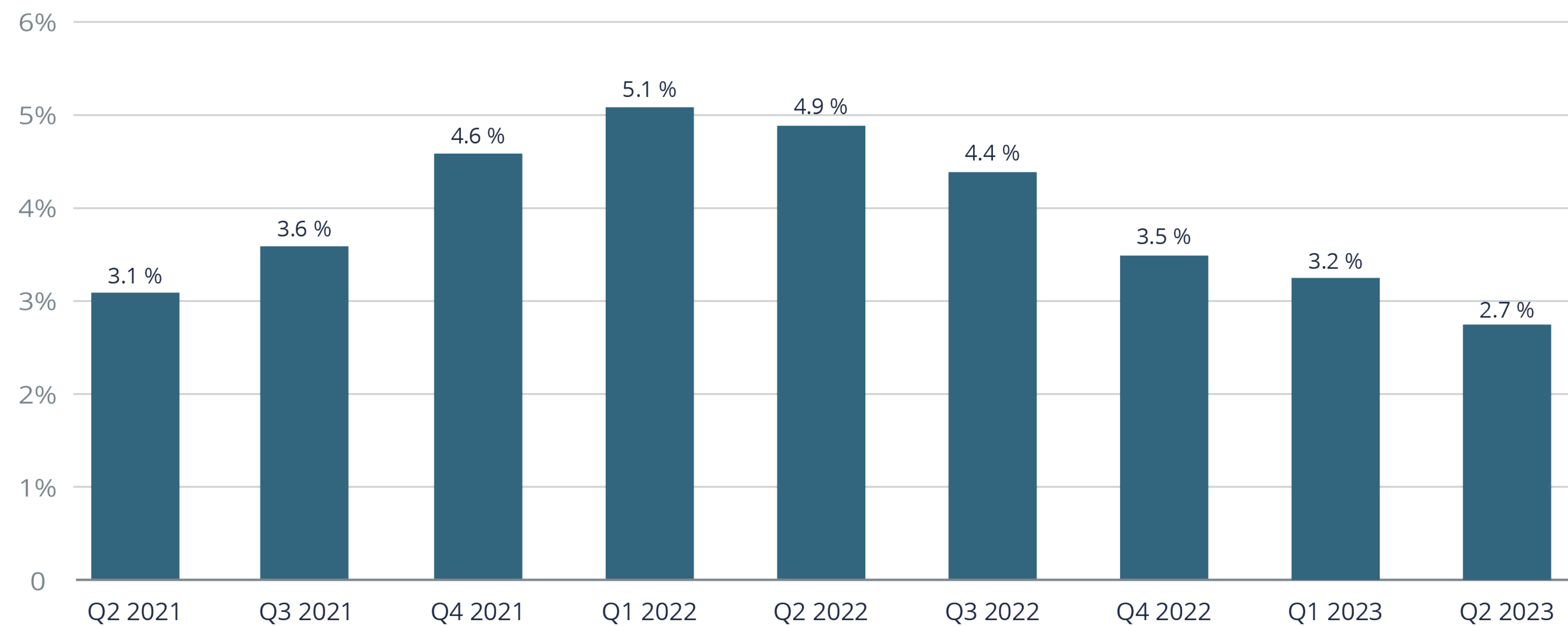
Transactional Insurance Market Update

Emily Maier, Stacey Hammer, and Tyson Freeburg

3.1 Fierce Competition Lowers Rates

The market continues to adjust to reduced deal flow and smaller deal sizes. There is fierce competition from carriers, and we are seeing rates dropping to between 1.9%–2.5% on average. Additionally, the standard retention—the amount of loss the insured must bear in the event of a claim before the policy limit kicks in—has decreased from 1% of purchase price to 0.75% on average, with many underwriters offering an initial retention as low as 0.5%. Terms and conditions are also getting broader for buyers.

Average Rate as a % of Limit by Inception Quarter



Source: Woodruff Sawyer

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What does this pricing trend mean for M&A insurance buyers? It's a good time to get reps and warranties insurance (RWI), especially for deals that underwriters historically have been more cautious about.

In the past, we normally received five to seven non-binding indications letters (NBILs)—as of midyear, we're now receiving about 15 NBILs per submission. More good news for buyers: We've seen very few deal-specific exclusions at the submission stage, and underwriters are willing to take on certain risks to make their quotes more competitive.

Carriers have also shifted their thinking on limits, opening the door for lower mid-market transactions that would have otherwise used a traditional indemnity structure. For "small deals" with an enterprise value below $20 million, we used to recommend a limit of at least $5 million. It's now much easier getting terms for limits as low as $3 million—while keeping the same rate as larger deals.

FAQs on the Q3 2023 Reps & Warranties Insurance Market >>

Read our FAQ blog that answers your most pressing questions about the current state of the M&A market.

4.0

Transactional Insurance Top Trends

The underwriting market has grown in the last two years, leading to the low premiums and retentions we're now seeing. We'll dive into these trends as well as other hot topics affecting the M&A market.

4.1 Trend #1: Use of Secondaries Continues to Rise

The increase in use of RWI for secondaries continues to be an ongoing trend that we don't see changing. There is also an increase in so-called "hybrid" secondaries, where the secondary has a wider set of operational reps and warranties being added to the previously sought basic ones. We still only see a limited market appetite for excluded obligations, which is hampering the potential wider growth and adoption of this product, although diligence on the part of buyers is a sticking point that the market can't fix.

The Rise of RWI in Secondary Financing >>

Learn what you need to know about RWI for secondaries, insurance due diligence, and how to price and acquire the coverage you need.

4.2 Trend #2: Further Price Drops May Be Unsustainable

It's unclear how much further the market can drop. Pricing below 2% is wonderful for clients, but the marketplace must be able to sustain itself long term, especially as these are multiyear products.

4.3 Trend #3: New Products Multiply

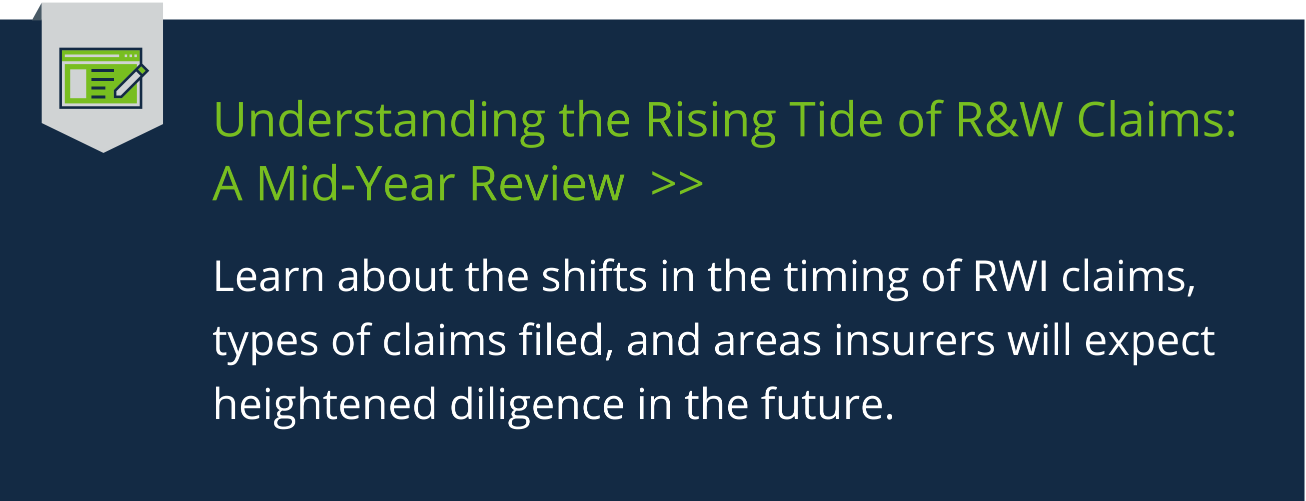
There is a proliferation of new product concepts. We've seen the introduction of an RWI "light" solution, with synthetic reps for small transactions. In this solution, instead of the insurance mirroring the reps and warranties as written in the sale and purchase agreement, they are predetermined by the underwriter. This obviously leaves room for gaps, but it greatly reduces the diligence requirement. Underwriters have made various attempts at writing RWI on a portfolio basis, and we see growing interest in insurance being attached to litigation funding deals to offset risk.

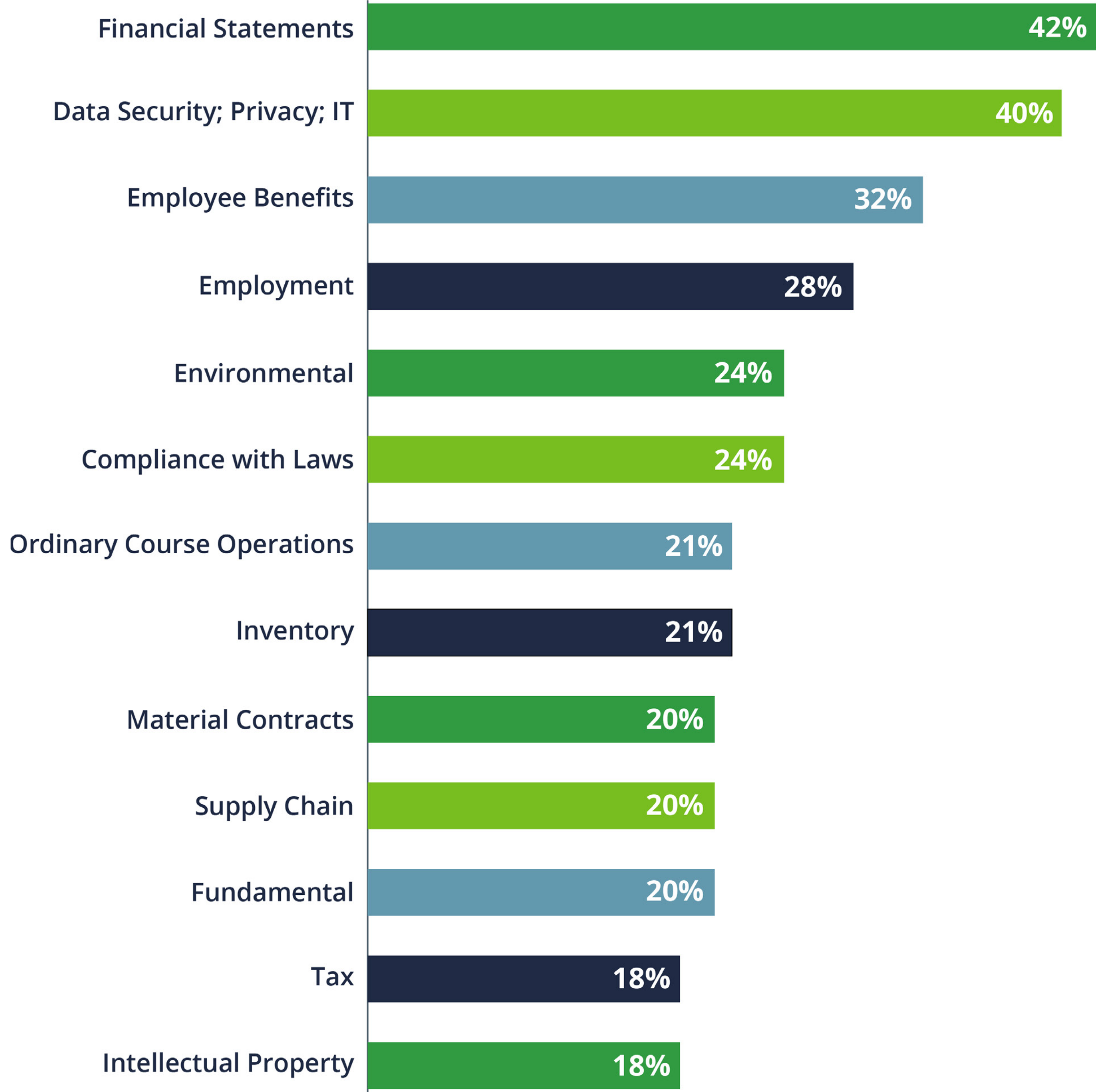
4.4 Trend #4: Retentions Drop to New Lows

Perhaps the most interesting change from a market development perspective is the slashing of retention rates. For a long time, 1% of enterprise value was the norm, dropping to 0.5% after a year. We are now seeing retentions start at between 0.5%–0.75% from day one. This will have a major impact on claims trends moving forward, as we expect this will lead to a rise in claims.

4.5 Trend #5: Claims Activity Rises

We have seen an uptick in claims activity, which is a standard phenomenon across all insurance lines in a downturned economy. This will result in the appearance of lower rates of claims satisfaction simply because insureds are making a greater number of speculative claims attempts. However, with the lowering of retentions, we expect to see greater claims activity overall and so we expect to see some fundamental changes in the number and value of claims across the board.





Note: Respondents were allowed to select more than one answer.

Source: Lowenstein Sandler RWI Insurance Claims Report 2023

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Reps and Warranties Insurance: The Basics

Reps and Warranties Buying Guide

Tax Liability Insurance: The Basics

Guide to Transactional Risk

Guide to D&O Insurance for SPAC IPOs

Guide to D&O Insurance for De-SPAC Transactions

D&O Looking Ahead Guide

**Whiteboard Breakdowns:
Making the Complex Simple with 3-Minute Videos**