



**Gallagher**

Insurance | Risk Management | Consulting

# Private Equity Risk Outlook Survey 2020



## ABOUT GALLAGHER

Founded by Arthur Gallagher in Chicago in 1927, Gallagher (NYSE: AJG) has grown to become one of the largest insurance brokerage, risk management, and human capital consultant companies in the world. With significant reach internationally, the group employs over 33,000 people and its global network provides services in more than 150 countries.

Gallagher's London divisions offer specialist insurance and risk management services. We provide bespoke policy wordings, programme design and risk placement solutions, and consulting support across a range of specialisms.

We manage complex, large, global risks on a direct and wholesale basis and serve as primary access point to Lloyd's of London, London company markets, and international insurance markets.

**We help businesses go beyond their goals.**

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# Introduction

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Hindsight is a wonderful thing. At the start of the year, global private equity (PE) firms had mixed reviews of the outturn to 2019 and were cautiously positioned for the new decade. Little did they know what lay ahead.

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**T**hrough the course of 2019, capital flows into PE had remained robust, even as the clouds gathered on the horizon for global growth. Rising trade tensions between the US and China dominated the news agenda, muting annual GDP growth at just 2.3%. In the midst of the uncertainty, a dovish turn from global central banks pushed out expectations for interest rate rises even further, driving yield-hungry investors to commit even more capital to private equity. According to Preqin, more than USD500bn of capital flowed to global private equity funds in 2019, with uncalled capital reaching USD2.5bn trillion by the end of the year.<sup>1</sup>

As the capital inflow increased, so did valuations, and the consensus across both public and private markets seemed clear; the global economy was late cycle and a downturn seemed inevitable.

The experience of recent months has shown that the impact of a downturn is less about timing and more about how firms react, respond, and recover.

Few would have anticipated the source – and the scale – of the crisis when it came. It remains difficult to comprehend or attempt to quantify the impact of the COVID-19 pandemic on global society, economies and the outlook for businesses, growth and investment.

The crisis has pushed many PE firms and their limited partners into a state of crisis control. Rapid re-assessment of underlying exposures, sector impacts, lost revenue streams and support of

more resilient sources of income, will be critical to the short-term response.

Over the next 12-18 months, firms' ability to continue to mitigate risk and flexibly respond to opportunities will be crucial. Initially, funds' focus will be centred on fighting fires across existing exposures, before turning to their obligation to deploy capital on behalf of investors.

Risk management will be a key component of both processes, as firms navigate their road through the recovery.

In Q1 2020 Gallagher undertook research across more than 250 global PE firms. We gauged their views on recent performance, their strategic direction and the strategic role of risk management and insurance in ongoing portfolio management, their relationships with limited partners (LPs) and the structural shifts in train across the private equity landscape.

Through the course of this report, we assess how firms were positioned ahead of the crisis, and the extent to which new geographies, sector exposures and risk management frameworks can feature as firms navigate the new operating environment.

We also draw insights from PE firms' approach to risk and de-risking, their knowledge of the insurance market and the extent to which they currently unlock value and protect themselves and their portfolio companies through the strategic use of insurance products.

Through any transaction or indeed as part of ongoing portfolio management,

firms must consider how they might be impacted by a broad range of risks, whether through balance sheet provisions, third party disputes, employee litigation, varied types of exchange exposure, IP breaches or other liabilities affecting the target and/or management teams.

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**The experience of recent months has shown that the impact of a downturn is less about timing and more about how firms react, respond, and recover.**

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<sup>1</sup> <https://docs.preqin.com/samples/2020-Preqin-Global-Alternatives-Reports-Sample-Pages.pdf>

CHAPTER ONE

# A brave new decade? PE confidence at the start of 2020

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# Assessing the outturn

Global investors committed more than

## \$500bn (USD)

to PE strategies in 2019, pushing global assets under management by PE firms to

## \$4.1tn (USD)<sup>2</sup>

In a year headlined by bumper deals, there were both notable transactions including Blackstone's USD18.7bn takeover of GLP's US warehouses and EQT's USD10.1bn purchase of Nestle's skincare unit - and disappointments, including the collapse of Apollo's USD15bn purchase of Arconic.

Despite the challenged outlook for global growth, rising geopolitical tensions and fears of an impending downturn, the majority of global private equity firms reflected positively on their 2019 performance. Nearly nine in 10 firms (88%) told us that the 2019 outturn had been in line with, or exceeded expectations.

Firms at the larger end of the spectrum in terms of size were among the least positive in their assessment of prior year performance. A third of firms with assets under management (AUM) of over GBP500bn deemed the outturn to have been ahead of expectations, while a fifth (22%) reported their year had been worse than expected.

US (95%) and UK-based firms (90%) were more positive than their peers in Asia, where just 72% of firms felt that they had surpassed or met their performance expectations - perhaps a reflection of the relative maturity of US and UK PE industries versus Asia.

At strategy level, growth equity firms were more positive than their counterparts running buyout strategies. Half of growth equity firms outperformed expectations last year, versus 38% of buyout firms.

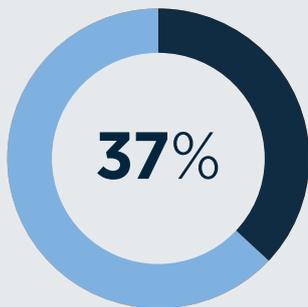
# 88%

of global private equity firms deemed the outturn to have been ahead of expectations

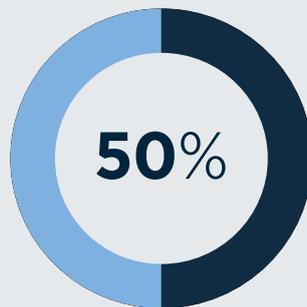
<sup>1</sup> As at June 2019: <https://docs.preqin.com/samples/2020-Preqin-Global-Alternatives-Reports-Sample-Pages.pdf>

# Market conditions

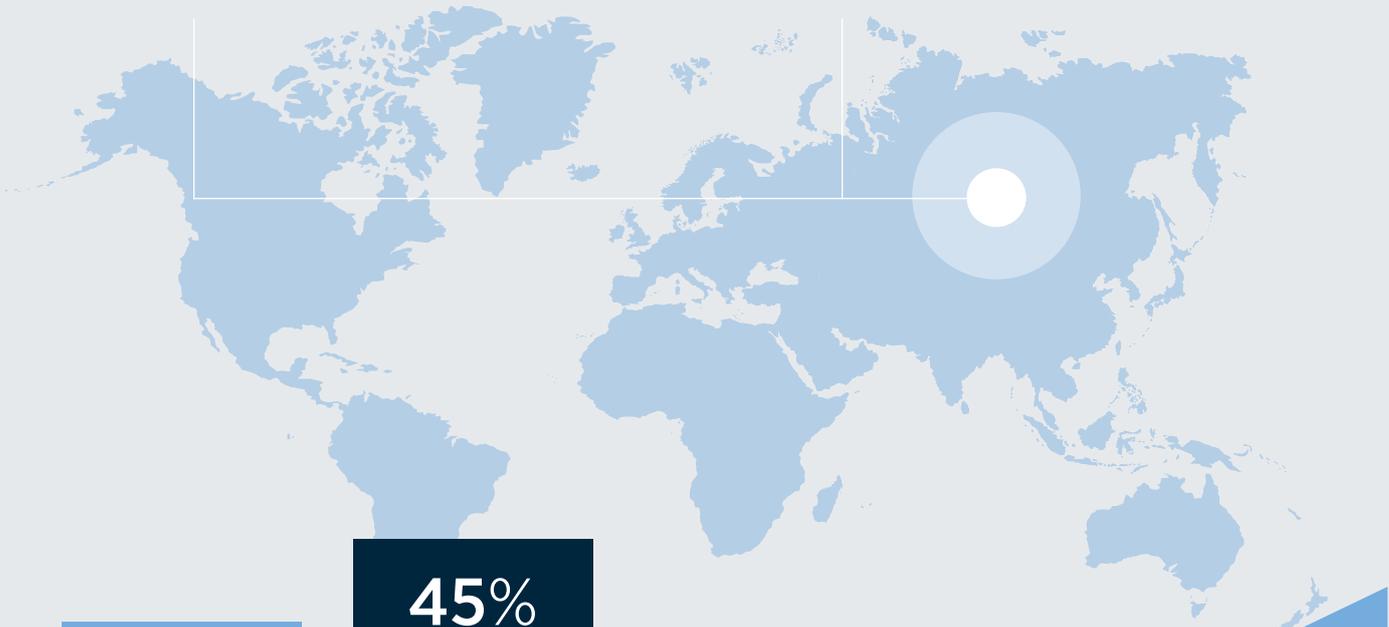
We asked firms about the impact of market conditions on their investment performance and business operations through the course of the year.



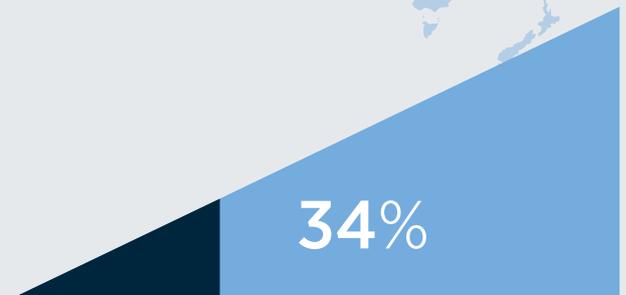
told us that market conditions had prevented the deployment of capital, rising to



for Asia-based firms, as intense competition to deploy capital drove up valuations.



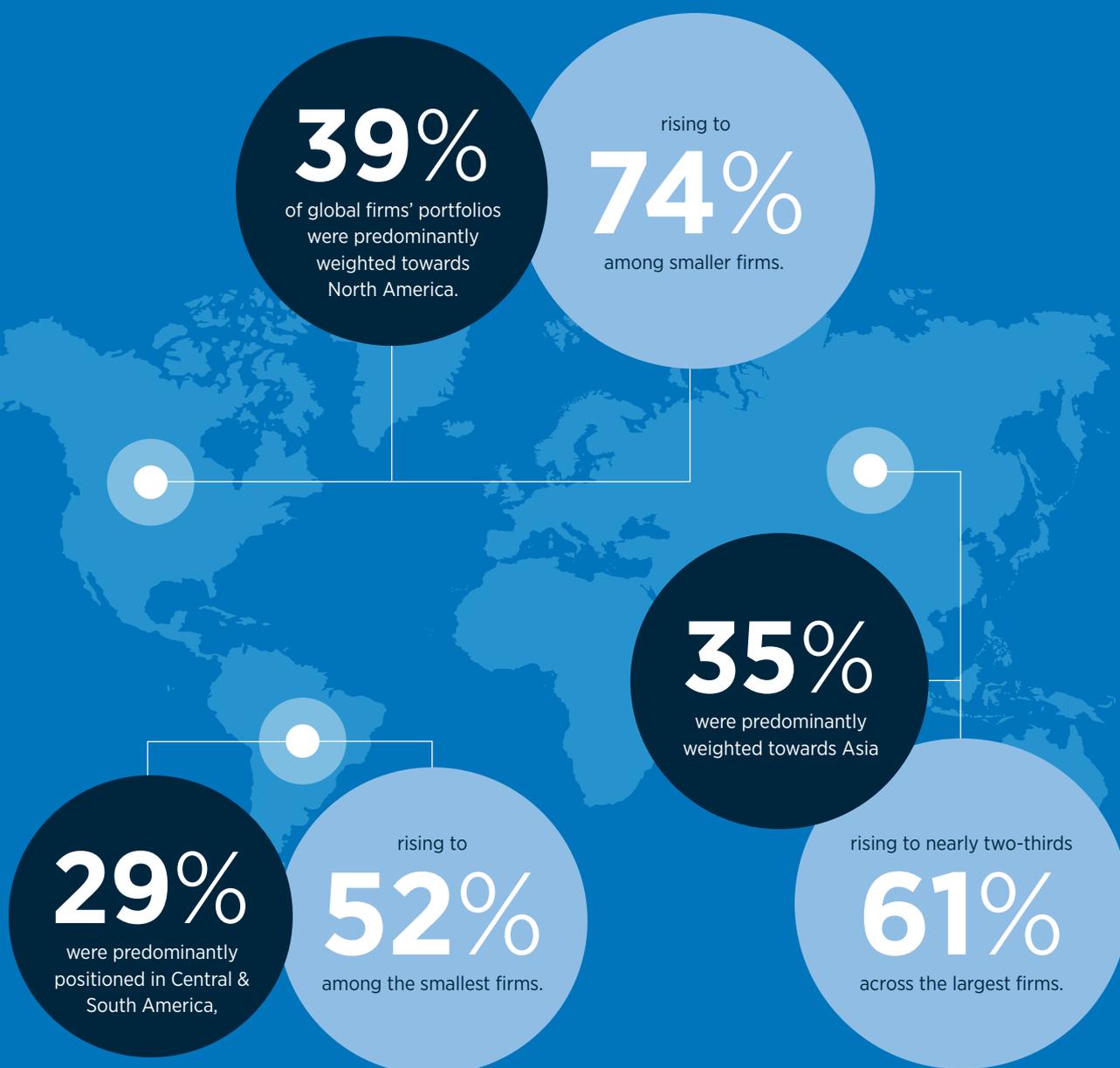
35% said the backdrop forced a shift in geographic weighting, rising to 45% for firms of between GBP10-100bn Assets Under Management (AUM).



34% of firms expanded their workforce in a bid to better harness opportunities in the investment environment; this response was more common among mid-sized firms.

# New horizons

Firms' current and planned adjustments to geographic positioning may now also evolve as lockdowns ease and economies start to recover at different rates. At the start of the year:



**T**here was evidence of a degree of home-bias with regards to US and Asia-based firms, with roughly half of firms reporting predominant exposure to their home market.

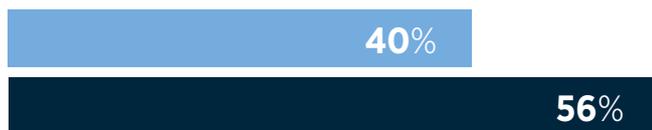
In terms of focus areas for new investments over the course of 2020, Central & Eastern Europe was the region in focus for 38% of UK-based firms, while 44% of US-based firms had plans to pursue opportunities in their home market. 41% of Asia-based firms reported a region-agnostic approach.

38% of UK-based firms reported plans to actively avoid or down weight exposure to Asia through the course of the year, a strategic decision potentially driven by ongoing uncertainty around global trade. Tensions have risen as a result of the US-China trade war, but also due to increasing focus on the role of Chinese corporations in global technology and data innovation and the potential threat to individual privacy.

The impacts of the pandemic may significantly constrain firms' ability to invest overseas in 2020, but before the global scope of COVID-19's impact became clear, plans to reduce exposure or exit specific regions were already being shaped by:



Economic sanctions for 40% of firms, rising to 43% of UK-based firms.



Economic weakness for 40% of firms, rising to 56% of Asia-based firms



Political instability for 37%, rising to 43% of UK-based firms



Market liquidity for 36%, rising to 43% of Asia-based firms.



## The Gallagher View

### Charles Russell

Head of Transactional Risks, Gallagher

At the start of the year, the majority of global PE firms were reflecting positively on the prior year and cautiously positioning for 2020.

It is interesting to consider that the largest firms were among the most negative in their perceptions of recent performance, ahead of an unprecedented shock to the global economic and growth outlook. As firms consider their next steps and longer-term strategy through a radically altered outlook, the insurance market is responding to growing risks.

In 2020 we are now seeing a combined effort across the transactional risks space to create a Contingent Risk Insurance market. Underwriting teams have increased their appetite and underwriting authority by hiring accountants, solicitors and specialists in litigation, IP, insolvency, and corporate restructuring.

Over the next few months, the ongoing downturn in mergers and acquisitions (M&A) deals will allow more transactional risk insurance teams the time and impetus to explore legal contingent style risks, in what is likely to be a radically different environment.

M&A transactions have typified a "seller's market" over recent years, but the dial is now likely to swing in favour of buyers, who must now optimise their ability to respond as opportunities arise.



CHAPTER TWO

# Sector exposures

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We will have to wait until the outturn of 2020 to gain a more measurable insight into the financial fallout of COVID-19 across the global private equity industry. Until then, underlying portfolio exposures, leverage and liquidity management will determine how firms fare through the second half of this year.

**A**cross the globe, the knock-on impacts of the pandemic have varied significantly across sectors. PE firms' and funds' sector exposures and concentration will dictate the extent of the damage to a certain degree, and the scope of the response required.

Leisure and hospitality industries for example, encompassing hotels, restaurants, gyms etc, have been almost universally negatively impacted by the pandemic. At the start of the year, just 8% of global PE firms reported exposure to leisure and hospitality. Post-lockdowns, operations across leisure industries will continue to be impacted by extensions to Government-mandated social distancing measures, the end of furlough packages and the wider 'return to work' schedule. The varied effects of post-lockdown life on leisure activities, be it travel, restaurants or large events, can be observed across China and other Asian jurisdictions, which have emerged from lockdowns ahead of Europe and the US.

Extractive industries and the energy sector have both suffered major supply and demand disruption. At the beginning of the year, just over one in 10 firms reported exposure to extractives (11%) and energy (14%). With structural challenges clouding the

outlook for global aviation and travel volumes long-term, and supply and demand set to suffer ongoing disruption, exposure to these sectors may inevitably create additional stress within poorly diversified PE portfolios.

Nearly a fifth of firms (17%) reported retail sector exposure, increasing to a quarter (24%) in the UK. The retail sector is comprised of a broad mix of businesses, underpinned by diverse strategies and varying splits of offline/online presence. In the coming months, retail-focused portfolios may well face prolonged firefighting, as COVID-19 accelerates the structural shifts already underway, while empty stores and high streets will present PE real estate owners with a range of new risks

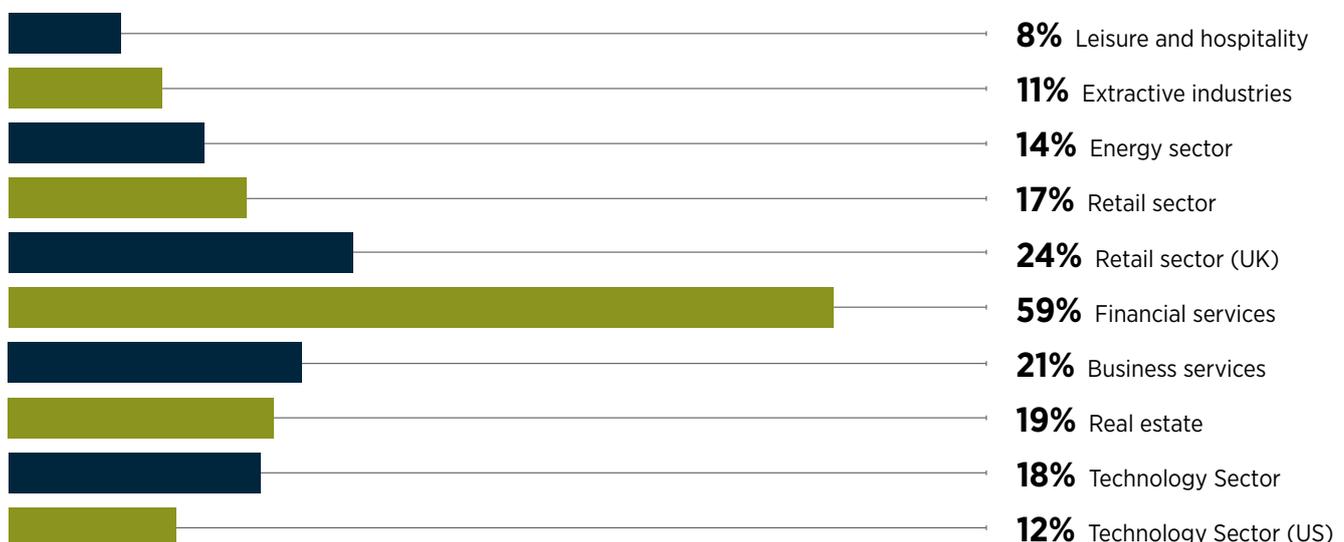
At the start of 2019, private equity firms' top three exposures were financial services (FS) (59%), business services (21%) and real estate (19%).

The presence of FS across global PE portfolios may be explained in part by the disruptive growth of fintechs. Business services also comprises a disparate universe of companies, ranging from accounting and enterprise software to SME energy and telecoms contract switching. This sector is particularly popular in the UK, where a quarter of firms report exposure.

Nearly a fifth of firms (18%) reported allocations to real estate, an illiquid asset class where values tend to move more slowly, and the impacts of the pandemic will hit rent collections from tenants before impacting asset values. In terms of strategic shifts, the pandemic is likely to accelerate investors' flight to core and quality already driven by continued quantitative easing and the knock-on suppression of 10-year government bond yields, the global risk-free rate. Longer-term, the shift to working from home may accelerate two pre-crisis trends. First, businesses' need for flexible working environments, as opposed to more traditional office environments, and second, a refocus on quality and wellbeing of employees within the office.

Nearly a fifth of firms (18%) also cited technology sector exposure, offering access to broader disruptive growth trends, particularly among US-based firms of which 22% reported holdings in this area.

### EXPOSURES BY SECTOR



# Harnessing technology – an accelerating opportunity set

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When firms were asked about their approach to specific sectors over the next 12 months, a prominent trend emerged across all regions.

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**M**ore than half of US (56%), UK (50%) and Asia-based firms (63%) plan to invest in the tech sector over the year ahead, adding to the already fierce competition for quality and high-growth assets in the sector.

From a strong base, the role technology has played through the crisis, and will continue to play through the recovery, can only serve to accelerate growth trajectories – whilst also increasing competition.



## The Gallagher View

**Charles Russell**

Head of Transactional Risks, Gallagher

More than ever, tech's disruption is breaching traditional sector boundaries, with cloud transition and the advent of 5G driving the growth of a new generation of companies. Through the crisis, the world is being forced to adopt technology, which may lead to an acceleration in technology adoption rates long after the crisis subsides, and society normalises.

From a structural perspective, many emerging PE technology targets have evolved with the support of venture capital, supporting a healthy pipeline of opportunity. In the post-COVID-19 era, tech may well be the only game in town for a while, so firms seeking to upweight their allocations to this space will need to be agile in their efforts to identify sector risks.

CHAPTER THREE

# Strategic shifts: holding periods and exit strategies

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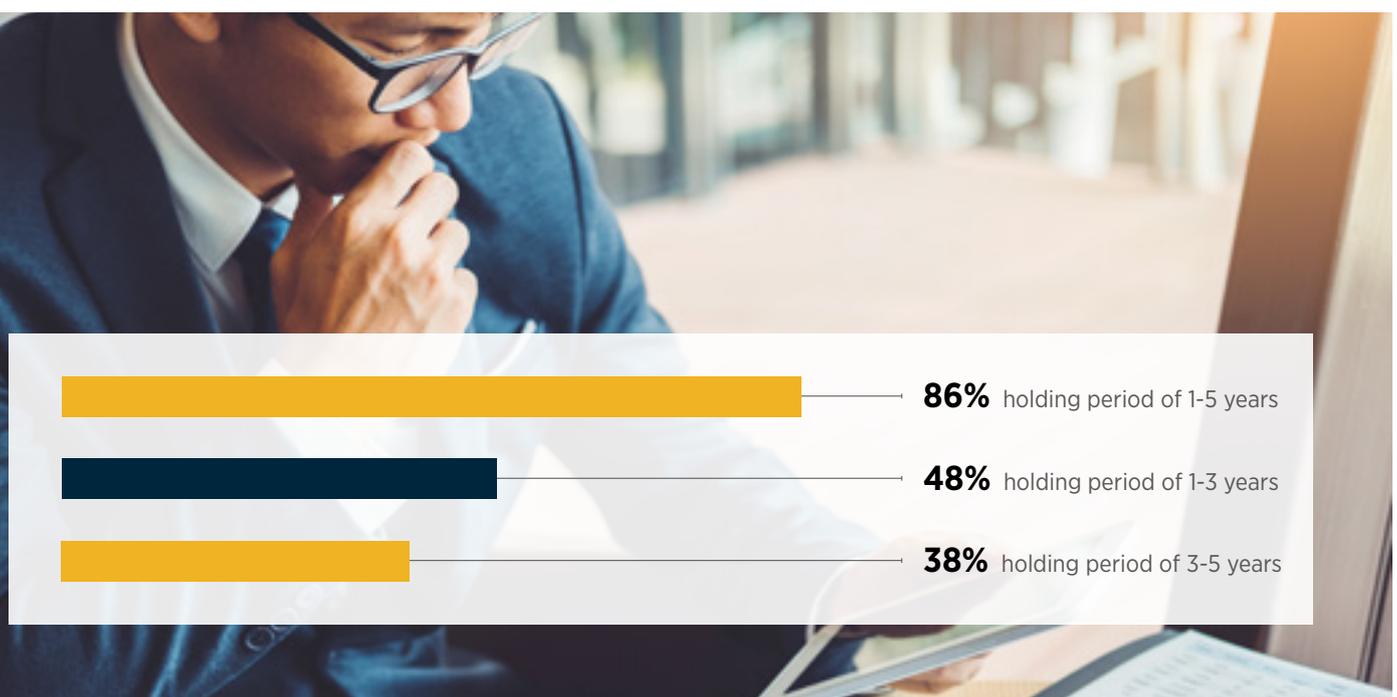


# Holding periods

The life cycle of PE funds typically track a 1-5-year time horizon for capital deployment in new investments. Through this period, fund managers manage the progress of their investments and can opt to make liquidations, distributions and further calls on investor commitments.

**L**onger term plans are typically associated with a more muted economic outlook or poor performing assets, as the industry saw following the global financial crisis. According to Prequin,<sup>3</sup> the median holding period across all exits fell to 4.3 years in 2019, well below the 6.0 years seen in 2014.

Nearly 9 in ten (86%) global PE firms surveyed at the start of the year reported an average holding period of 1-5 years; 48% reported a holding period of 1-3 years, while 38% cited a 3-5-year term.



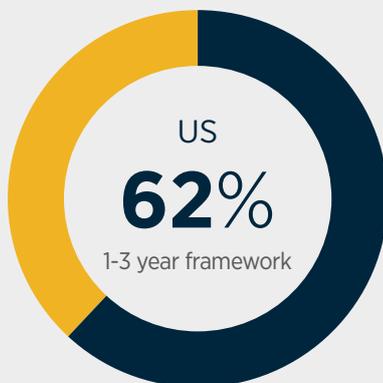
<sup>3</sup> Page 14: [https://www.bain.com/globalassets/noindex/2020/bain\\_report\\_private\\_equity\\_report\\_2020.pdf](https://www.bain.com/globalassets/noindex/2020/bain_report_private_equity_report_2020.pdf)

### There were some notable regional discrepancies in hold periods:

In the US, firms are operating under shorter average time horizons. Nearly two thirds of firms (62%) operate within a shorter 1-3-year framework, with just under a quarter (24%) working towards exit over a longer 3-5-year period, a distribution pattern which broadly maps across all fund sizes and within both growth equity and buyout strategies.

In the UK, firms are more evenly distributed across term periods. 48% are operating within a 1-3-year framework, versus 40% over 3-5 years. 7% reported 5-10 year holding periods, while just 2% hold assets in perpetuity.

In Asia, firms are generally structured over longer holding periods. Just over a fifth (21%) operate on a 1-3-year time horizon; 59% over 3-5 years; and 15% over 5-10-year periods.



When considering how current average term holding plans compare to five years ago, when firms were operating in a pre-Brexit, pre-Trump, pre-trade wars environment, in anticipation of interest rate rises (which have still failed to materialise and now seem a particularly distant prospect), 41% of firms report an increase in term plan from 1-3 years.

# The evolution of the Initial Public Offering (IPO)

At a structural level, aggregate shifts in term plan horizons can, at least in part, be attributed to the evolution of exit strategies and within that frame, initial public offerings.

In a low interest rate environment, debt finance options have become an increasingly appealing option for companies versus raising capital by listing and selling equity on public markets.

Late in the cycle and faced with an increasingly uncertain economic outlook, PE firms may opt to pursue a strategic exit rather than push on towards IPO, enabling the sale of entire stakes.

**When asked about how the trend of PE-owned companies remaining private for longer was impacting their business:**

**24%**

of firms said the trend has resulted in changes to their holding period.

**49%**

of firms said it had increased their focus on dividend payments throughout the ownership cycle, rising to 57% of US-based firms.

**36%**

of firms said the trend had increased demand from limited partners for co-investment options, a more prevalent trend among smaller to mid-tier firms which, by nature of their size, will more commonly commit capital alongside other institutional partners, in some cases across the capital structure.

**31%**

said the shift had demanded new operational and internal capabilities at fund level, a trend more pronounced among mid-tier firms. Additional operational and internal capabilities would typically include additional risk management requirements, given that significant value creation is taking place.

## The Gallagher View

### Charles Russell

Head of Transactional Risks, Gallagher

“The traditional ‘funnel to IPO’ function provided by private equity has changed significantly since the global financial crisis. The rising fees, mounting paperwork and scrutiny of the listing process is proving to be significant deterrence to many companies, but PE firms and their partners should not take the view that staying private reduces risks. Regardless of the context, the creation of long-term value requires strategic risk oversight.

Strategic buyers remain a popular exit channel enabling acquisitions in pursuit of scale, product expansion or regional diversification. Across the market we are seeing buyers adopt an increasingly sophisticated, risk-led approach to M&A.

Given the economic repercussions of COVID-19, we anticipate such activity to be more muted for a period. All stakeholders - buyers, sellers, lenders and financial sponsors - will be paying close attention to the impact that the virus has on a target’s financial performance, which is likely to paint an uncertain if not negative picture going forward. For now, many are taking a wait and see approach.

Later in the year, we expect the frequency of M&A transactions to recover. M&A insurance will play a vital role and firms have an opportunity to prepare the groundwork for a frothier period of deal-making.”



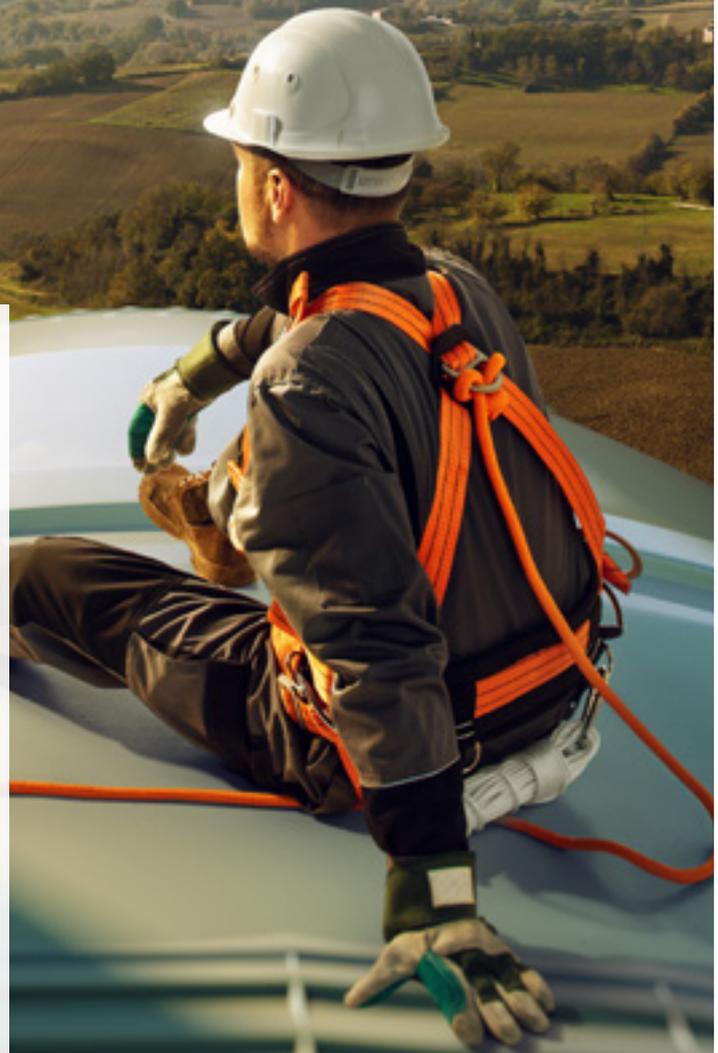
## CHAPTER FOUR

# ESG – accelerating in PE?

Momentum gathered pace behind sustainable investment through the course of 2019, bringing the environmental, social and governance (ESG) credentials of the global private equity industry under increased scrutiny.

The link between companies with good ESG practices and long-term, sustainable value is widely recognised. The COVID-19 pandemic has brought broader sustainability issues into particularly sharp focus including increasing scrutiny of corporate debt burdens, treatment of employees and wider corporate purpose.

In the short-term, the push for increased investor oversight will raise requirements around non-financial disclosures, in a bid to clamp down on “greenwashing” in the marketing of ESG and impact funds. While experience of and approaches to ESG varies significantly across the industry, many PE firms are operating on the assumptions that pressure from investors will only continue to ramp up.



# Behind the curve?

Against this backdrop, a surprising 78% of global PE firms (across both growth equity and buyout strategies) said that their investment process is unaffected by rising requirements around ESG disclosure, rising to 89% among the smallest firms (GBP1m - 10m AUM). In the UK, this figure was even higher, with 84% of firms stating that they are investing unencumbered by rising ESG requirements.

**T**hat said, the 22% of firms where investment processes are being affected by ESG reported a broad range of impacts.

In the UK, the 16% of firms reporting an impact of increasing ESG requirements, cited a range of knock-on effects. ESG disclosures have driven one firm to undertake extended analysis of organisations' business and working models, their carbon impressions and their approach to climate change. One firm said that analysis around ESG criteria was helping to "determine the future financial performance" and providing a "positive impact on investments". Not all firms took a positive view, however, with one firm stating that ESG disclosures were "limiting the opportunities to invest - just another weight on everyone's neck".

In the US, 26% of firms reported knock-on impacts from rising ESG regulation and scrutiny. One firm said they have been "limited by such disclosures", another raised fears about the knock-on effects of increasing ESG scrutiny on their sources of capital, return outlook and access to specific regions. Others said the adoption of an ESG approach had supported effective portfolio management and improved diversification.

In Asia, 24% of firms reported an ESG impact on the investment process. One firm said that increased disclosures had caused changes to both fund criteria and holding periods and led to the adoption of a more balanced approach in its investment process, taking additional time and effort to assess the suitability of the investment.

## The Gallagher View

**Charles Russell**

Head of Transactional Risks, Gallagher

"ESG, impact and sustainability has shot up the ranks of investor priorities, and a growing number of global firms are factoring environmental, social and governance issues into their investment decisions and portfolio management. Private markets have lagged the public sphere in this regard for some time but rising regulatory and stakeholder pressure is forcing the industry to catch up.

We believe that the consideration of a broader set of non-financial risks and potential stresses to be a core part of a strategic risk management approach. The creation of a broader risk framework to support transactions, portfolio management and exits can only serve to smooth PE firms' journey through the cycle."

CHAPTER FIVE

# Structuring risk protections – how global PE firms are buying insurance cover

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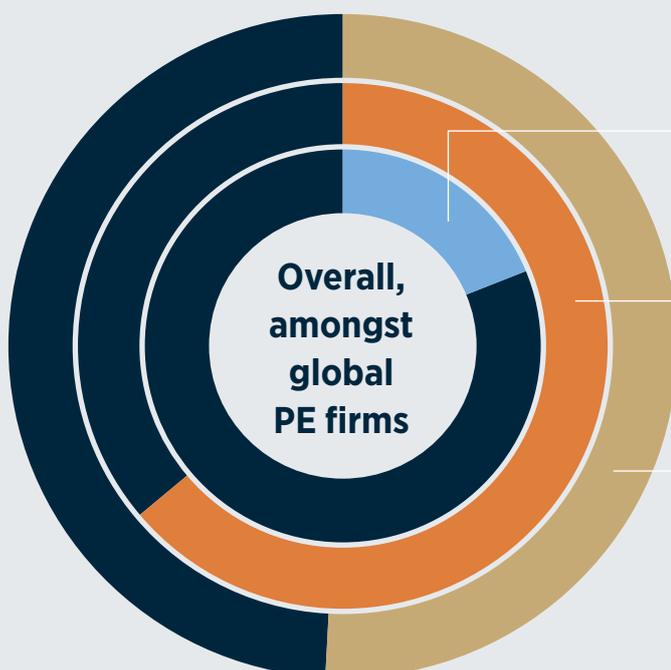
Risk management is a core focus for PE firms throughout the lifecycle of funds - from initial due diligence (DD) and deal execution, through to ongoing portfolio management. Insurance plays a key role within firms' broader risk strategy, mitigating the risk of investment performance being directly impacted by operational weaknesses and other latent risks.

**W**ith an estimated 30% of the world's GDP having been in lockdown through much of Q2 2020, severely impacting commercial activity, the wide-ranging impact of COVID-19 is likely to accelerate trends that were already shaping the insurance market globally. Last year, use of M&A insurance products, such as Warranty and Indemnity (W&I) and Representations and Warranties (R&W) insurance, reached record highs, as global PE firms increased their use of cover to offset risks at both firm and portfolio level.

Now, in a challenging market environment, PE firms' ability to benefit from pricing dislocation, respond quickly to emerging opportunities and deliver outperformance over an investment cycle is, to some extent, reliant on their risk management capabilities.

However, firms' knowledge of the insurance market and strategic use of cover remains relatively limited.

At the start of the year, just 17% of firms said they had a comprehensive knowledge and awareness of the insurance market and use cover for capital efficiency. Comprehensive knowledge levels were similarly low among US and UK based firms, falling to 13% for Asia-based firms. As would be expected, a higher proportion of respondents from larger funds (28%) reported comprehensive knowledge.



**19%**

Nearly one fifth have limited knowledge and are unsure what insurance the firm has in place.

**64%**

Just under two thirds have some understanding of the insurance market and its role in PE.

**51%**

Over half are aware of firms are aware that there are specific policies providing cover against long-tail transitional tax risks.

Given the wide variation in investment approaches, time horizons and governance structures across PE, it is unsurprising to see significant differences in the way PE firms buy and structure their insurance cover.

- More than half (56%) of global PE firms buy insurance at fund/firm level, and on behalf of portfolio companies.
- Just under one third (31%) of firms buy insurance at firm/fund level only, with underlying portfolio companies responsible for structuring and purchasing their own cover. This trend was higher in US and UK markets (32% and 33% respectively) versus 26% among Asia-based firms. A higher proportion of growth equity firms (33%) buy cover in this way, versus 24% among buyout firms, reflecting the likely differences in ownership.

- One fifth of global firms buy insurance for acquisitions on an individual, deal by deal basis. This trend is relatively higher levels in Asia (24% vs. 18% in US and 19% in UK respectively), again with a relatively higher proportion of buyout vs. growth equity firms (28% vs. 18%).

When it comes to buying insurance cover at firm level, more than half (53%) of global PE firms' insurance is bought by Chief Financial Officers or Finance Directors, rising to 63% in Asia.

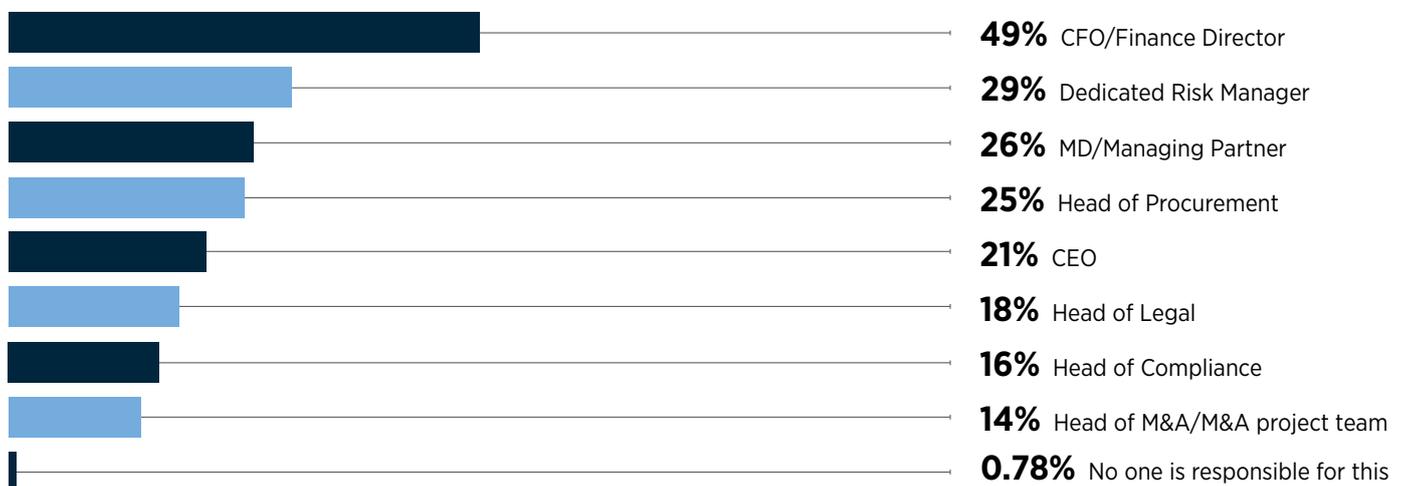
More than a quarter (27%) buy insurance via their dedicated risk manager, rising to 38% in the UK and falling to just 15% in the US. 23% of firms' CEOs sign off on their insurance. This trend is more than twice as common in buyout firms (40%) vs. growth equity businesses (18%).

**Who is responsible for purchasing insurance within your company?**



Within portfolio companies, PE firms reported similar levels of reliance on CFOs and dedicated risk managers, with marginally less responsibility reported among CEOs.

**Who is responsible for purchasing insurance within your portfolio companies?**





## The Gallagher View

### Charles Russell

Head of Transactional Risks, Gallagher

“While it is encouraging to see that the majority of global PE firms have some understanding of the insurance market, there is some way to go before the use of insurance as a strategic tool becomes widespread. Less than a third of PE firms and their portfolio companies have a dedicated risk manager in place and so it is incumbent on the insurance industry and those in charge of the finances to increase the dialogue and knowledge around risks that can be addressed through the use of insurance.

In today’s uncertain landscape, with illiquidity and balance sheet exposure a concern for both GPs and LPs, improving deal certainty, enhancing a negotiating position, or mitigating certain financial risks should be prioritised.

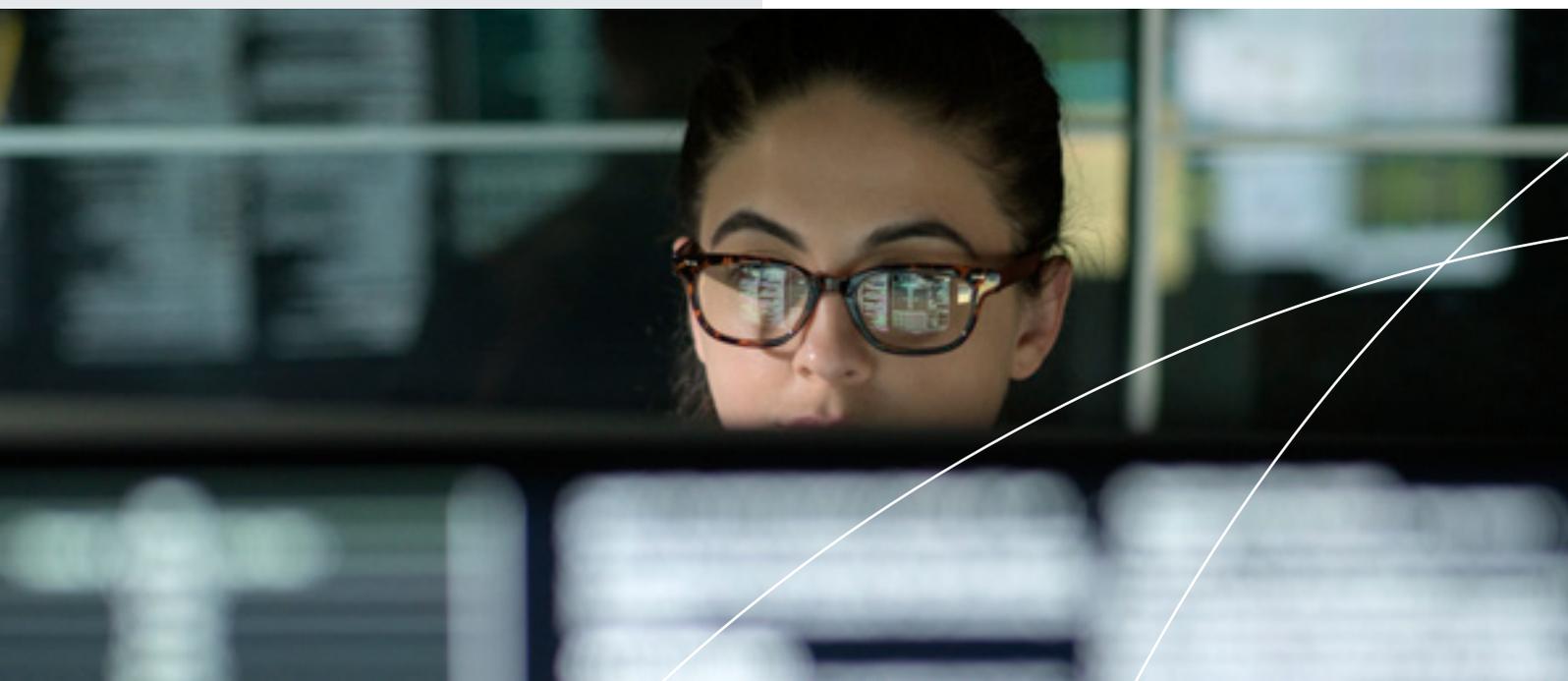
Beyond this, with PE firms – be it opportunistic acquirers or long term investors – operating in increasingly complex environments, having the knowledge that tax issues found in due diligence, for instance, can be wrapped into W&I coverage, can be of great value. Especially when it enables deals to complete seamlessly with no need for specific seller indemnity or purchase price adjustment. Tax insurance is just one example of the ways in which the insurance market can be used to the benefit of PE firms and their portfolio companies.”

### Matthew Solley

Managing Director, Structured Credit & Political Risks, Gallagher

“Whilst we see application for structured credit and political risk insurance within the PE sector, it is the latter where we have seen the strongest demand. Low interest rates and surplus capital available for developed market assets have led investors to look increasingly towards developing economies for yield. However, whilst at an economic level the return of an emerging market investment may look appealing, it comes with a different set of challenges such as the risk of government interference or certainty of access to hard currency.

In our experience, the risk premium that an investor may require in order to compensate for this additional risk is frequently greater than the cost of insurance against these and other political perils. This can deliver a significant arbitrage for the insurance buyer. Thus, while the client may still need to manage its investment in an arguably more challenging jurisdiction, it can have the comfort of knowing that political risk insurance is in place, enabling each investment to be assessed on its objective merits and not just its jurisdiction.”



CHAPTER SIX

**What insurance  
cover are global  
equity firms buying?**

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There are considerable differences in the way that equity firms are using insurance to protect and enhance their business and there is further opportunity in the sector for insurance to be used more strategically and become a key enabler of activity, particularly in these times of economic uncertainty.

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**T**here is also a marked difference in how businesses arrange cover for portfolio businesses, and also in advance of and during transactions.

Covers such as Public Liability, Professional Indemnity and Directors' & Officers' (D&O) have never been more relevant with the additional risks that businesses are currently facing.

One of the changes in the insurance market over the last twelve months has been the growth of tax insurance. Due to increased 'in-house' tax experience, it is now commonplace for known tax issues flagged in Due Diligence (DD) reports to be wrapped into Warranties & Indemnities (W&I) cover. This enables deals to complete seamlessly with no need for specific seller indemnity or purchase price adjustment.

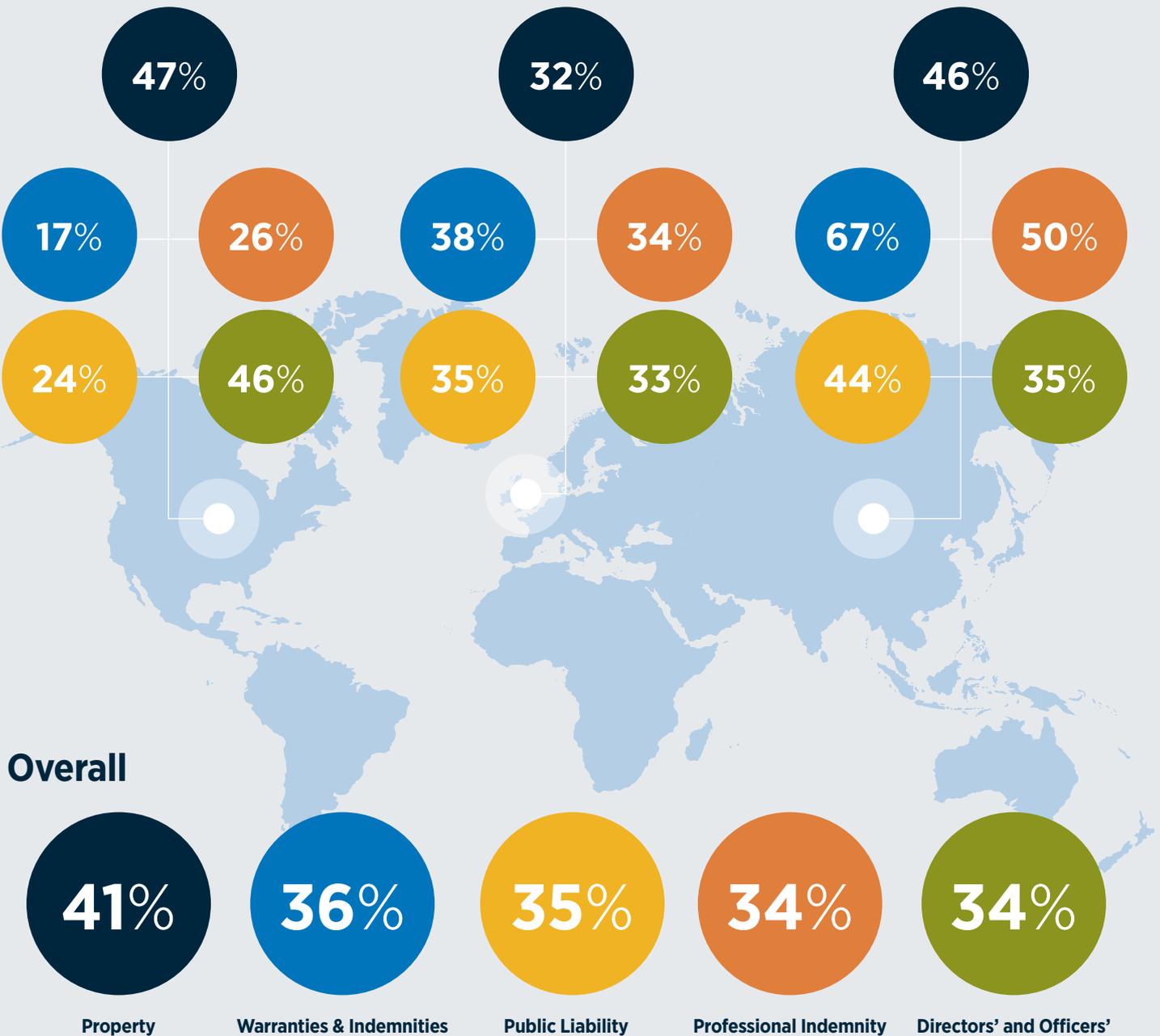
Claims notifications have also increased significantly over the past year, driven by a greater volume of M&A policies being placed, and insurers providing broader coverage, insuring larger deals across an increased number of jurisdictions. Following completions, buyers have started to analyse whether warranties given by the seller underpinned certain valuations prior to closing. Increasingly, insureds are relying on M&A insurance in scenarios where financial statements have proven inaccurate.



# Buying cover

In this context, Property, W&I, Public Liability, Professional Indemnity and D&O insurance were the top five types of cover bought by global PE firms at the start of the year.

There are some significant regional differences in purchasing trends, with a relatively higher proportion of Asia-based firms buying W&I (67% vs. 17% US and 38% UK), Public Liability (44% vs. 24% US and 35% UK) and Professional Indemnity cover (50% vs. 26% US and 34% UK) than their US and UK-based counterparts.



## Insurance cover

- Property
- Warranties & Indemnities
- Public Liability
- Professional Indemnity
- Directors' and Officers'

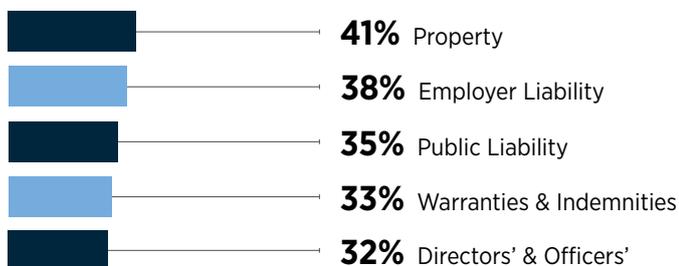
# Insurance as part of due diligence (DD)

By integrating insurance into their DD process, PE firms can better pinpoint potential exposures, uninsured or underinsured areas; improve visibility on potential insurance costs and make provisions for any additional insurance requirements.

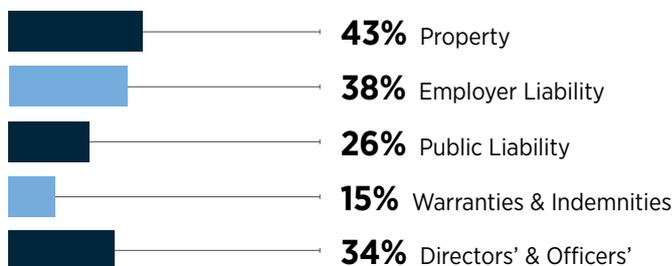
Insurance DD also provides an opportunity to assess how cover of portfolio companies could be incorporated or wrapped into existing firm-wide arrangements, creating potential for enhanced operational and cost efficiencies.

At the start of the year, Property, Employer Liability, Public Liability, W&I and D&O were the top five covers assessed by global PE firms during DD.

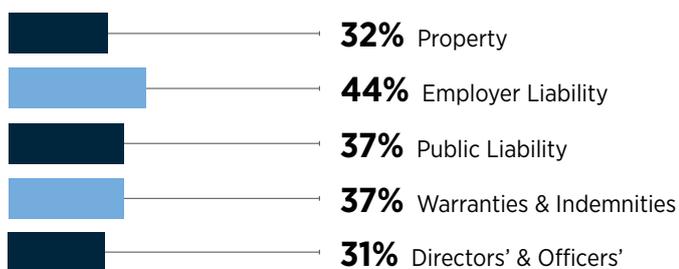
## Overall



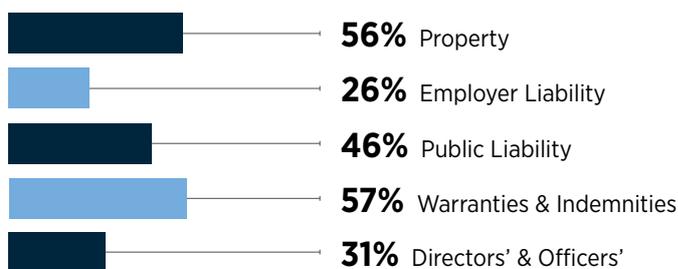
## US



## UK



## UK



# Directors' & Officers' (D&O) insurance

At the start of the year, nearly half (47%) of PE firms reported arranging D&O cover on behalf of their portfolio companies, versus one third at firm level.

**F**irms ranked protection of personal assets, mitigation of new risks on account of fraud and related criminally motivated activity (social engineering) and corporate risk appetite as the top three drivers behind their purchase of D&O cover.

The global D&O market had already hardened considerably - increasing premiums as a result of tightening insurer capacity and greater underwriter selectivity on risk appetite - during H2 2019, and the impact of COVID-19 has significantly exacerbated these challenging market conditions. Claims events in the US, such as securities class actions have reached historically high levels, with claims reserves limiting the capacity and cover in the corporate liability market. As a result, rates are likely to remain high.

Industry sectors that were already under strain in 2019 at the renewal of their D&O insurance are now attracting an even higher level of underwriter scrutiny. The rapid evolution of COVID-19 and the shape of the recovery is causing uncertainty as to how long business operations will be impacted. The travel, leisure and hospitality sectors have become incredibly challenging to design D&O insurance programmes for, with exclusionary language being applied and with requests for COVID-19 specific underwriting information. This scrutiny has also rapidly moved into other sectors such as retail and financial services, and we expect nearly every sector to be affected in some way.

Renewals will remain challenging for some time to come. Rate rises, restrictions on coverage, additional exclusions including, increasingly, restrictions around COVID-19 related claims and lengthy renewal negotiations are now all commonplace. Those businesses that are renewing their cover in the second half of 2020 will need to work closely with their insurance brokers and should take the following steps to ensure that they are prepared:

## Prepare for your renewal with the following steps:



**Go global:** firms should be flexible and ready to trade with new underwriters. All possible global capacity should be considered, and all options sought out.



**Get in early:** engage with your broker early. In a hard market, insurers refer certain risks 'up the chain' to senior management. Gather your information in plenty of time and expect insurers to ask more questions than usual.



**Consider personalities:** as insurers become more selective, so should firms. Underwriters are all different - some individuals are more experienced and knowledgeable than others, some prefer some risks over others, or prefer to handle renewals in a particular way. Brokers will be able to advise clients on the most suitable choices of underwriters and will ensure that the selection is aligned to specific requirements.



**Be flexible:** there may be alternative structures and programme designs to ensure all available options are considered to secure your renewal. If there is an option for greater utilisation of a captive, it should be considered. If you are willing to take more risk on the balance sheet, it can be modelled. As brokers we can develop the strategy - clients just need to be ready to consider all the options.



## The Gallagher View

**David Ritchie**  
Managing Director of D&O, Gallagher

“From our perspective, the market is likely to continue to get tougher, as we continue to navigate a very uncertain 2020, with D&O premiums at historic highs. The true effect from COVID-19 is unlikely to be felt for a period of months or even years, and the market for D&O will remain a difficult place in which to do business. In spite of this, Gallagher remains open for business and fully operational during this lockdown period and we appreciate just how uncertain times have become for all of our clients, especially on an individual basis.”

# Warranty & Indemnity (W&I) insurance

Over the past five years, just 16% of global PE firms have purchased W&I insurance - covering breaches in representations and warranties given in the sale of a business - for all transactions. One fifth of UK (20%) and US (19%) firms bought cover for all transactions, falling to just 4% among Asia-based firms. While 44% of firms reported buying W&I, nearly one in 10 (9%) have never bought W&I cover, rising to 13% in Asia.

During DD,

## 37%

of UK firms assess their targets' W&I cover, rising to 57% in Asia and falling to just 15% of US-based firms.

At strategy level,

## 14%

of growth equity firms bought W&I for all transactions vs. 26% of buyout firms. More than two-thirds of growth equity firms assess targets' W&I cover during DD, relative to just 16% of buyout firms.

## 55%

More than half of firms bought W&I cover direct from an insurer or consulted a legal advisor (51%) while 36% consulted an insurance broker in their purchase of cover.

**W**hile 2019 was a record year for the W&I market, the rate of claim notifications against W&I cover looks set to increase again in 2020. This is due in part to the COVID-19 crisis, but principally as a result of the volume and range of deals now requiring insurance.

The knock-on effects of greater demand are already being felt through the underwriting process, with insurers increasingly demanding various COVID-19 related exclusions, and restricting cover for warranties that could be sensitive to the pandemic's impacts. We expect the underwriting process to become more granular for some of the hardest-hit sectors, particularly leisure and hospitality. We anticipate an increase in the rate of claims against W&I cover placed before and after the COVID-19 crisis. Recently acquired businesses that suffer over this period will look to all available insurances, including their W&I. For example, warranties that talk to material contracts will be closely examined post close, especially if the target's financial performance were to drop significantly.

That said, we anticipate W&I pricing to remain broadly similar in 2020. In the near-term, although the risk profile of some businesses and properties may have increased due to COVID-19, insurers are essentially competing to win a smaller pool of deals. In the long-term, whilst we expect to see continued competition in the M&A insurance market, we don't expect to see a continued decrease in W&I premium rates, mainly due to the growing number of claims paid out by insurers.

Over the longer term we expect continued investment and recruitment in the W&I market as insurers expand into different territories. Similarly, whilst traditionally hiring corporate lawyers, insurers are recruiting an increasing number of specialists from different professions and industry sectors to deliver broader coverage and a streamlined process. As more W&I and tax insurance policies are negotiated and placed, what might have traditionally taken a number of weeks or months, might take a number of days by the end of 2020, supporting PE firms to capture opportunities more flexibly as they arise.

# Conclusion: Partnering with the insurance market

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As PE firms around the world emerge from the lockdown and prepare for their next period of capital deployment through the recovery, identifying the risks, finding the right partners in the insurance market and structuring the right cover will become ever more important.

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**A**s we have explored through the course of this report, we expect the hard market conditions already felt in the insurance market to continue, and to get tougher this year, given the current unprecedented levels of uncertainty. With this in mind, there is more value to be sought than ever in partnering with an experienced insurance broker, rather than going direct to insurers.

With insurers currently in a position of influence given the worldwide drops in capacity and appetite across almost all insurance classes, buyers of insurance need to work alongside experienced, and specialist London market insurance partners to understand how insurance can be used strategically to help secure yield, to open new markets, to protect against long-tail risks, and ultimately deliver growth.

We have already seen these partnerships pay dividends - even in one of the newest and most niche parts of the insurance market - the contingent risk insurance (CRI) market. Typically employed in a transactional context, CRI is increasingly being used to mitigate standalone risks such as disputes, liquidations and shoring up balance sheets. The CRI market has allowed for creative balance sheet management, enhancing access to capital, lending, and higher valuations. Funds and companies are reducing administrative costs by quickly winding up portfolio

companies or preparing targets for sale by packaging known risks into CRI programmes. Other products, ranging from Structured Credit and Political Risks, M&A and Tax Insurance can be strategically deployed to help firms meet their commercial objectives. More routine covers, ranging from Property, to Cyber, to D&O, can also be structured in new and more progressive ways, to ensure that these covers are best supporting the current and future strategies of the buyer.

For PE firms, the future looks to be a tale of two halves. In the short-term, efforts will be concentrated on recovery, executing any tactical pivots, before considering longer-term strategic decision-making around the future direction of their fund, sector, and geographic exposure, holding periods, or their approach to sustainability.

Risk management will play an increasingly important role. The events of 2020 will reconfigure the opportunity set for global PE firms for some time to come. From the simple transactions to the most complex cross-border deals, the insurance market can help to facilitate negotiation, structure policies and mitigate risks to enable a smoother process.

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All data unless otherwise stated from research conducted by Censuswide, on behalf of Gallagher, between 1 March and 31 March 2020, amongst Private Equity firms and houses based in the US, UK and Singapore, with 250 managers and above.

### Conditions and Limitations

This note is not intended to give legal or financial advice, and, accordingly, it should not be relied upon for such. It should not be regarded as a comprehensive statement of the law and/or market practice in this area. In preparing this note we have relied on information sourced from third parties and we make no claims as to the completeness or accuracy of the information contained herein. It reflects our understanding as at 13/08/2020, but you will recognise that matters concerning COVID-19 are fast changing across the world. You should not act upon information in this bulletin nor determine not to act, without first seeking specific legal and/or specialist advice. Our advice to our clients is as an insurance broker and is provided subject to specific terms and conditions, the terms of which take precedence over any representations in this document. No third party to whom this is passed can rely on it. We and our officers, employees or agents shall not be responsible for any loss whatsoever arising from the recipient's reliance upon any information we provide herein and exclude liability for the content to fullest extent permitted by law. Should you require advice about your specific insurance arrangements or specific claim circumstances, please get in touch with your usual contact at Gallagher.

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