WOODRUFF SAWYER

LOOKING AHEAD TO 2023

PRIVATE EQUITY AND M&A

Predictions and Advice on Private Equity,
Due Diligence, and Transactional Risk Insurance

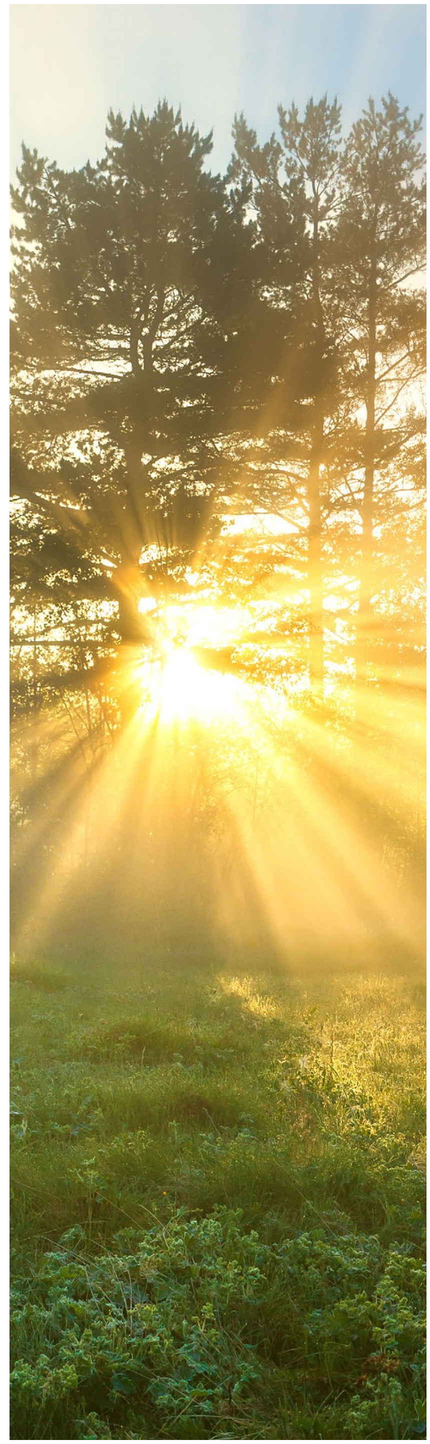
Insights You'll Find in This Report

When we look across our client base of 375+ funds and our advisory work on 150+ middle market growth equity, private equity, and strategic M&A US-based transactions in 2022, we see a wide variety of issues that are fundamentally reshaping how deal teams view and consider risk. These issues pertain to their active deals, current portfolio companies, and potential deal processes coming down the pipeline.

The first portion of our *2023 Looking Ahead Guide* focuses on trends and projections in the representations and warranties insurance (RWI) space, including a general market update.

The second part of our *2023 Guide* focuses on the due diligence side of the equation and identifies several key trends we have uncovered after working on hundreds of transactions in the middle market space.

At Woodruff Sawyer, we've been working with the private equity and venture capital community for over 25 years. On the transaction side, we consult and advise on over 150+ transactions per year, which include growth equity deals, strategic acquisitions, traditional private equity buyouts, and SPAC/de-SPAC transactions. Fund-level insurance and transactional due diligence work are in our DNA, and we've infused that institutional knowledge and expertise into this *Guide* to the private equity and M&A landscape in 2023.



Top Trends

Private Equity Is Facing Turbulent Times in 2022—The Need for Expert Advisory Teams is Critical

Public and private markets experienced a record year in 2021. According to Pitchbook, US private equity dealmaking eclipsed $1 trillion in total deal value. Add to that the significant uptick in the public markets related to traditional and SPAC IPOs as well as high-profile de-SPAC transactions, and it's not surprising that 2021 was one of the best years ever in terms of deals.

MARKET UPHEAVAL DECREASES DEAL VOLUME

In 2022, the macroeconomic and geopolitical backdrop has caused significant market upheaval and the M&A world is in a much different place than it was in Q4 2021. Some factors that have caused this upheaval include the highest inflation in 40 years, supply chain issues stemming from COVID-19, several interest-rate hikes, and Russia's invasion of Ukraine. This environment has led directly to significantly decreased deal volume and lower overall valuations for sellers. According to Pitchbook's *Q2 2022 US PE Breakdown* published in June 2022, "until a more stable environment has been established, deal activity will likely remain tepid."

Factors that have caused the market upheaval include:

1. The highest inflation in 40 years
2. Supply chain issues from COVID-19
3. Interest rate hikes
4. Russia's invasion of Ukraine

However, there is still a record amount of dry powder that needs to be deployed by US private equity firms—$3.6 trillion, according to Bain and Company's *Shifting Gears: Private Equity Report Mid-Year 2022* report. Pitchbook predicts "deal activity will likely pick up as GPs feel pressure to deploy capital, but this eventuality may be several quarters out." There was certainly some activity in the first half of 2022, but many of those processes were deals that kicked off in 2021. Going into the back half of 2022 and the first quarter(s) of 2023, activity is slowing down as deal pipelines soften due to buyers' and sellers' inability to see eye to eye on valuations. And, to top it off, a potential recession on the horizon could fuel the slowdown.

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MORE COMPETITION FOR PRIVATE EQUITY DEALS

What does this macro backdrop mean for the private equity insurance advisor? Generally speaking, it signals three things:

1. While there may be fewer deals in the market, competition for those deals among private equity firms will likely increase.

2. The private equity firms that do get deals under a letter of intent and move forward will need to work with significantly more speed and certainty to close the deals as quickly as possible.

3. If a recession does arise and stick around for several quarters, private equity firms will likely be highly focused on managing current investments' earnings before interest, taxes, depreciation, and amortization (EBITDA) margin and growth to weather the storm.

While not the top priority on a deal team's radar, insurance, employee benefits, and general risk management concerns are beginning to be 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.

Guide to Transactional Risk >>

Use our guide to insurance due diligence to help you identify, quantify, mitigate, diminish, or otherwise transfer the potential risks that could negatively affect EBITDA for the portfolio company.

SPACs: Special Purpose Acquisition Companies >>

Learn about SPACs (special purpose acquisition companies) from the experts on Woodruff Sawyer's SPAC IPO practice, a recognized leader in M&A transactions.

Top Trends

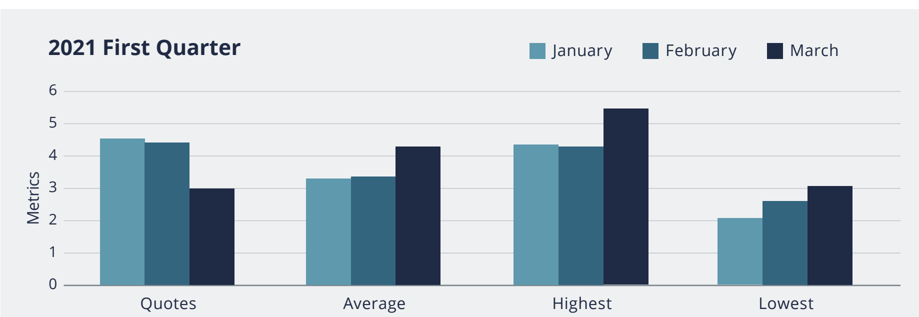
The Hard Market is Behind Us for Transactional Insurance

Lasting just over three months, the first-ever hard market to hit the transactional insurance space was over by the end of the first quarter.

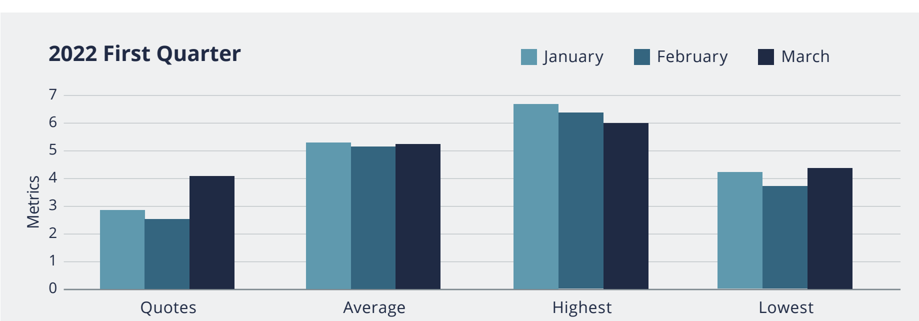
The entire RWI domestic market consists of 25 separate underwriting groups, which makes it a very small world by insurance standards. What this means is that the market adapted very quickly to changing circumstances, which were characterized by:

1. Slowdown of M&A activity across the board
2. Increased underwriting capacity both in terms of capital to deploy and underwriters to underwrite because of the increased activity last year
3. Increased capital deployment by underwriters

All the above resulted in a quick dropping of the pricing we saw toward the end of 2021, an increase in the number of quotes each risk received, and a return to more friendly underwriting terms and speed of execution.



Source: Woodruff Sawyer, Reps and Warranties Insurance 2022: First Quarter Round-Up



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Guide to Representations & Warranties Insurance >>

As representations and warranties insurance becomes increasingly mainstream, take a comprehensive look at this facet of coverage.

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Representations and Warranties Insurance: Return to Business as Usual

The combination of decreased deal flow, new market entrants, increased capacity, and an easing of staffing shortages to underwrite RWI have all contributed to a return to the pricing of early 2021.

This is good news for each deal, and we're also seeing the RWI market put its creative hat back on and try and find new avenues of coverage.

Here are a few of the trends we're seeing and how they'll impact 2023.

Trend #1: Secondaries Are on the Rise

We have seen an increase in the **use of secondaries** by private equity and even venture capital firms in the last year. Traditionally, this use has not been covered by RWI insurance for the following reasons:

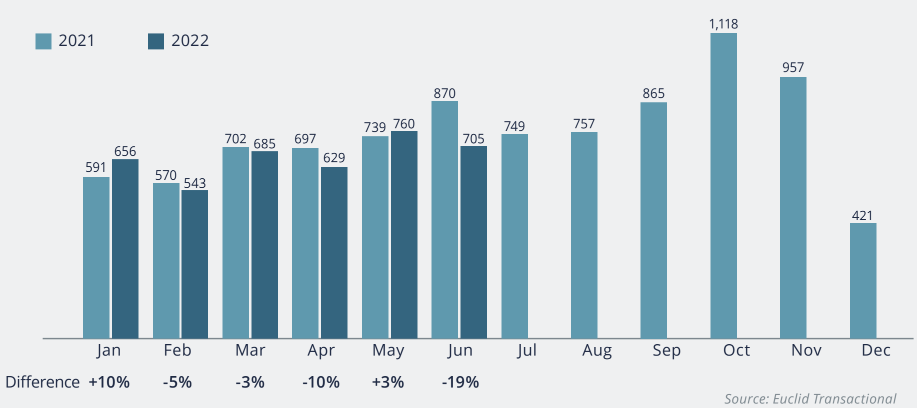
- Lack of diligence
- Desire for speed and simplicity in transaction
- Inability to cover excluded obligations

Certain underwriters have been able to overcome these challenges by producing a product that requires far less diligence and at a cheaper price. In certain circumstances, they can even offer coverage for excluded obligations.

Trend #2: The Soft Market Will Continue in 2023

The number of deals and the size of those deals have been decreasing since the end of 2020. For example, below is a snapshot of deals submitted to Euclid, one of the major players in the market.

The Number of M&A Deals Decreased from 2021 to 2022



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While we see a path to a more robust end of the year, we do not expect pricing to reach the previous fourth-quarter levels for last year.

Retentions are staying mostly constant at 1% of enterprise value, with continued downward pressure on deals larger than $500 million to around 0.75%. We believe this will remain the same for the remainder of 2022.

Trend #3: New Products Under Development

In addition to the rise in coverage for the secondary market, we are also seeing niche products being developed for new music rights portfolios and two new products for very small-scale policies for sellers.

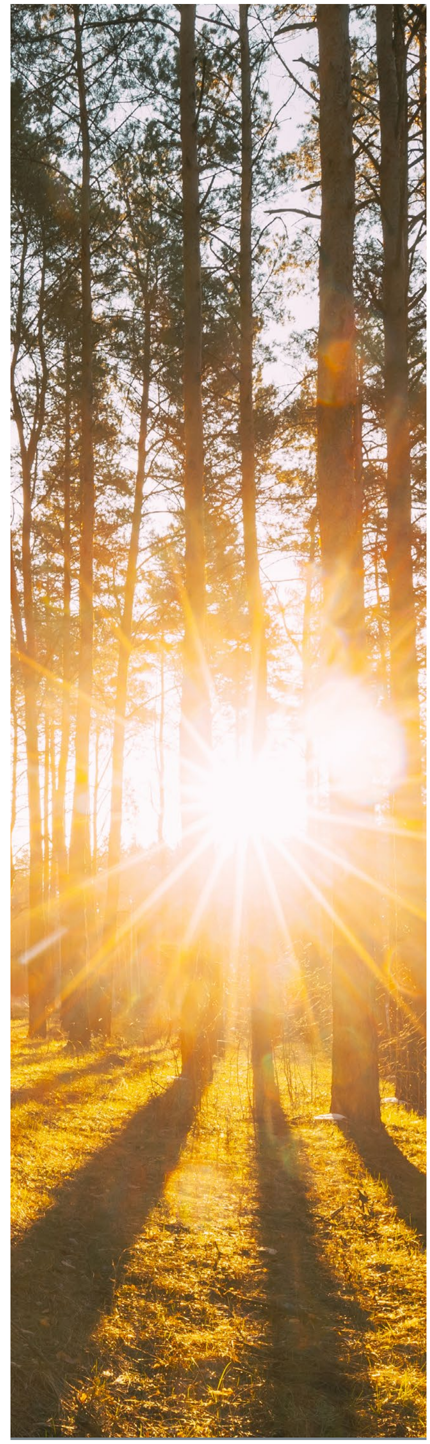
Trend #4: Increasing Underwriting Scrutiny in Key Areas Such as Insurance and Cyber

More and more frequently, underwriters will want to see fulsome due diligence around the underlying target's insurance program. Depending on the industry class, they may also want to see a more detailed IT and cybersecurity diligence report or memo. If a deal team does not perform diligence in these key areas, they should expect additional questions and/or exclusionary language related to things like management liability, cyber liability, and professional/E&O liability.

Trend #5: Claim Activity and How Insurers Are Responding

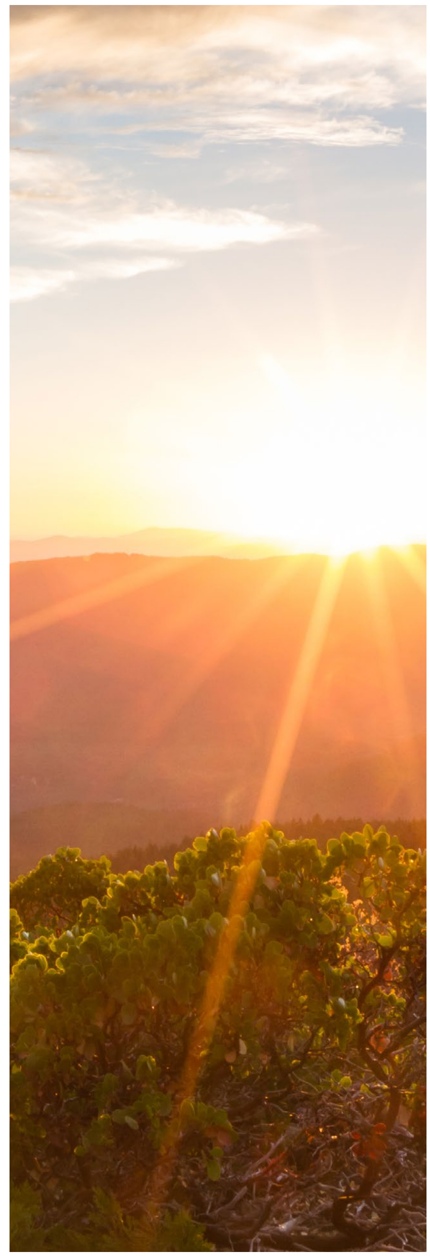
As insurers bind more R&W policies, they're seeing a corresponding influx of claims being noticed. In the past few years, the rapid growth of the industry and the number of insurers that offer products for M&A transactions have led to unprecedented competition, including a desire by carriers to position themselves as superior on the claims side. Carriers are eager to be perceived as easy to deal with when it comes to claims, reasonable in their scope of requests, and willing to pay out what is owed to their insureds.

Our most frequent questions from insureds include how a carrier is at paying out claims, whether the carrier is difficult to deal with, and how long it will take before they receive payment. With eight years of handling R&W claims and in-depth experience in handling insurance claims and coverage issues overall, Woodruff Sawyer's ability to provide comprehensive guidance to its clients is an asset in our arsenal. We know all the claim handlers and processes at the 20+ R&W carriers in the marketplace and are committed to keeping up on overall trends and the big picture as well as providing individualized service.



We have seen that approximately 15-20% of policyholders will, at some point in their policy period, notify us of a claim. This trend is apparent throughout the industry. Most claims noticed will occur within the first 18 months, as buyers begin to discover issues at the companies they have acquired and have the first year's financials audited. The huge push in the M&A world in the second half of 2021 led to an enormous number of policies being bound, which means that those in the industry are keeping an eye out for the beginnings of a slew of claim notices in the near future.

15%-20% of policyholders file a claim. Most claims are noticed within **18 months.**



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Trends in Insurance Due Diligence for Middle Market Private Equity Transactions

Based on our work on hundreds of middle market private equity and growth equity transactions over the last 24 months, we believe the following trends will continue to have an impact on transactions in Q4 2022 and moving into 2023.

Trend #1: Adding a More Sophisticated and Professional Insurance Program for Private Equity Ownership

In a "typical" middle market transaction, we find one of the following is true for most target acquisitions:

- The target has not implemented an adequate insurance foundation.
- The target has implemented an acceptable foundation and has acceptably covered core exposures but is missing pertinent and nuanced coverages.
- There does not appear to be a comprehensive, strategic approach to insurance and risk management.
- The target has little to no management liability or cyber liability coverage in place.
- The target has an inadequate limit or retention structure for various coverages.

> **An ongoing trend that we see in the insurance due diligence process is a need to professionalize the insurance program at the target company.**

Yes, most companies will have some kind of foundation of coverage in place, but the foundation is unsophisticated, and there is not a clear strategy surrounding the commercial insurance or employee benefits programs. This situation is, by no means, the fault of the management team; the management teams are not insurance experts, and they shouldn't have to be. When the company is sold to a private equity firm, however, that new owner will want to ensure the insurance and benefits programs are state-of-the-art in terms of coverage terms, conditions, and pricing, as well as offerings to employees (for employee benefits).

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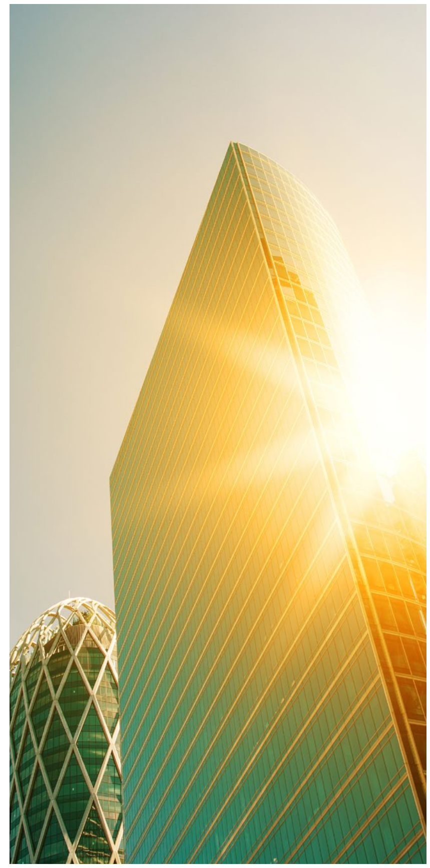
On the property and casualty side, most companies have an adequate foundation of coverage in place, but limits may be inadequate in areas such as commercial property, cyber liability, environmental liability, or management liability. As the deal closes, it is critical to fix any deficiencies and implement new coverages as needed. We also find that, in some cases, the company has obtained insurance from a local or regional insurer versus a national player. As the new private equity parent looks to close add-on acquisitions, the platform company needs to have a firm foundation of insurance with a reputable, national insurer that can underwrite business in every state and provide worldwide coverage for the platform company and any potential add-on acquisitions.



Trend #2: Cyber Liability Continues to be a Key and Constantly Evolving Risk

As we mentioned in last year's *Guide*, the cyber liability landscape is continuing to evolve as a key exposure for middle market companies. We believe this trend of increasing underwriting scrutiny surrounding cyber liability is here to stay for the foreseeable future. Key exposure areas are network security/hacking, ransomware attacks, cyber extortion, and social engineering/funds transfer fraud. As claims continue to increase in both frequency and severity across the lower and core middle market, rates and underwriting scrutiny will both continue to increase.

For private equity professionals, this means that, despite some reprieve right now for other segments of commercial insurance, the **overall cost of cyber liability** has been and will continue to increase year over year.

WHAT WE OFTEN FIND DURING THE DUE DILIGENCE PROCESS

During the due diligence process, we tend to find one of the following pertains to cyber liability coverage at the target company:

- No coverage is in place.
- Coverage is in place, but the limit is insufficient given the size of the company.
- The target company does not have adequate controls in place to mitigate a cyberattack.

During a diligence process, we often find the target company does not have an adequate cyber liability program in place. We may also uncover the company does not have adequate controls set up to thwart or mitigate a cyberattack from occurring. Controls such as multifactor authentication across various network platforms, VPN utilization, segmentation, and encryption are becoming standard controls that underwriters expect companies to have in place before quoting.

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During the due diligence phase, it's critical for the insurance advisor to perform a detailed analysis of the cyber liability policy's terms, conditions, pricing, and limit adequacy based on benchmarking. If any areas are found to be lacking, it is critically important to fix these gaps either before closing or at close. Deficiencies in coverage could cause issues with the RWI underwriting process. The RWI insurer will want to ensure:

- A policy is in place.
- Limits are adequate.
- If a policy is not in place, one can be put in place at close that provides full prior acts coverage.

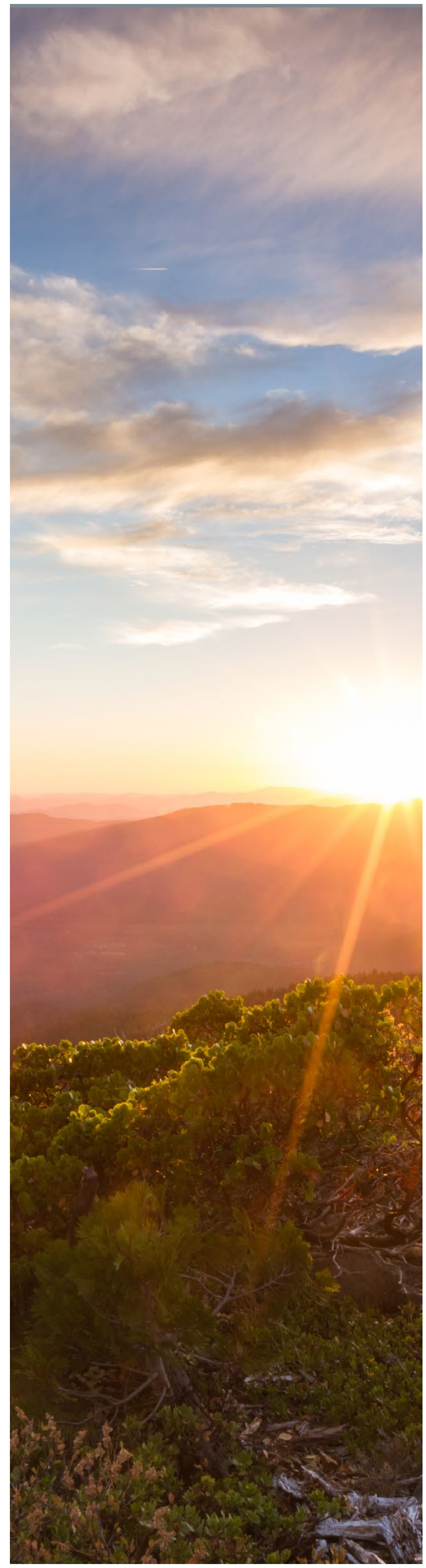
AN OWNERSHIP CHANGE MAY MEAN A NEW POLICY

Another recent trend in cyber liability is that insurers are becoming less willing to waive the change in control (CoC) provision that is triggered at close. All cyber policies will have this CoC provision, which typically notes that if/when more than 50% of the ownership of the insured company changes, the policy automatically converts to run-off. This conversion means either a new policy must be placed at close, or the insurer can opt to waive the provision and keep the existing policy in place. While most insurers have been willing to simply waive the provision, we are now seeing a trend where insurers are not as willing or unwilling to waive the CoC provision.

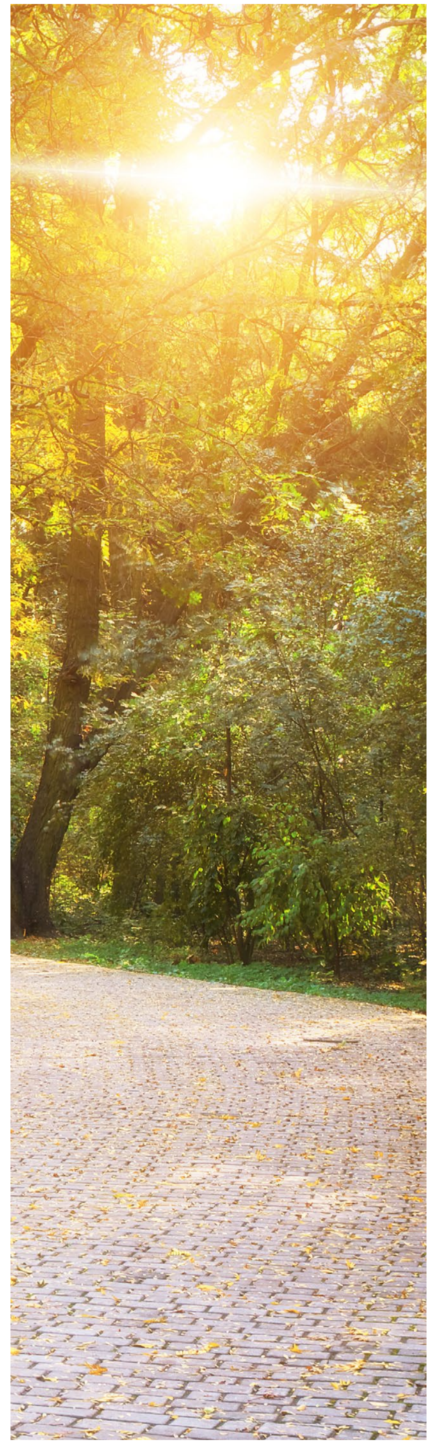
For platform transactions, this provision means a new policy must be placed at closing. For add-on transactions, the buyer should confirm what the go-forward plan is several weeks before closing. If the target will be rolled onto the existing buyer's cyber program, are there any issues with retroactive dates, additional premiums, etc., that need to be contemplated in the due diligence analysis? Answers to these questions could have an impact on the RWI side of the equation as well as the go-forward strategy and recommendations for pre- and post-close.

REVIEW YOUR IT CONTROLS & ENSURE ADEQUATE COVERAGE

As cyber liability continues to grab headlines in 2022, we would recommend private equity firms perform a broad review of the current cyber liability insurance policies in place and ensure the coverage is state-of-the-art. We also recommend reviewing the IT and systems controls in place as part of the due diligence process. Across myriad other loss scenarios for any given company, reducing cyber risk as a possible loss that could negatively impact EBITDA year over year is becoming more of a priority on operating teams' radars.



Trend #3: Portfolio Companies Are Rethinking Insurance as a Mechanism to Improve EBITDA Margin



As is the case with every transaction, private equity firms care about adjusted EBITDA margin, pure and simple. If EBITDA improves over time, the private equity firm will earn money on its investment in a portfolio company. When a firm buys or sells a company, a significant amount of time and effort is devoted to confirming and/or validating the adjusted EBITDA of the company because it validates the intrinsic value of the asset.

INSURANCE CAN HELP IMPROVE YOUR EBITDA

As we mentioned in our *2022 Guide*, insurance has traditionally been seen as a drag on EBITDA. Many private equity firms are now utilizing the operating partner approach to managing the broader portfolio. A key role for the operations team within a private equity firm is to help the portfolio company maximize EBITDA margin growth and improvement over time. Insurance has typically not been included in this discussion, but firms are now realizing that insurance can be used to not only protect EBITDA and mitigate losses but also improve EBITDA margin over the short and long term. By adjusting the structure of an insurance program and thinking more strategically about risk, portfolio companies can increase EBITDA margin year over year.

THE TRADITIONAL APPROACH TO WORKING WITH PE FIRMS ISN'T WORKING

As deal teams and operators look to take advantage of this trend, few insurance brokerage firms think about insurance in this manner.

Most firms use a three-tier approach to working with private equity firms:

- The first tier is the sales team that works with the private equity firm directly.
- The second tier is the centralized marketing or due diligence team that is staffed with industry-agnostic, generalist insurance practitioners who conduct the diligence.
- The third tier is the local, regional service team that will take over the portfolio company once the deal closes.

While this approach appears to work at a high level, the fundamental issue with this approach is during each of these "hand-offs" between teams, institutional knowledge about the private equity firm, deal, and individual transaction is lost, and the team that conducts the diligence typically doesn't work closely with the service team. In some cases, the service team may not even understand how private equity transactions work, but they are assigned to handle the go-forward brokerage for the portfolio company. This situation is a recipe for disaster as communication channels break down constantly.

To really know and understand the methods by which insurance can be used to improve EBITDA year over year on a particular transaction or during the hold period, the diligence team should have deep expertise in that specific sector where the target operates. Additionally, the same team that performs the due diligence should service the portfolio company post-close and implement the recommendations uncovered during the due diligence process.

Private equity firm deal teams and operators are noticing this trend ultimately helps their investments improve EBITDA margin pertaining to insurance. We believe this trend will continue in 2023.

> To use insurance as a lever to improve EBITDA on a transaction or during the hold period, the insurance diligence team should have deep expertise in the sector where the target operates. That same team should service the portfolio company post-close and implement the recommendations uncovered during the due diligence process.

Trend #4: Macroeconomic Conditions Are Affecting Insurance and Risk Management Decisions

On our deals throughout 2022, we've also noticed that the overall macroeconomic environment is negatively affecting the underlying insurance program decision-making process for target private equity firm transactions. Inflation and general macroeconomic business conditions are forcing risk managers and CFOs to reconsider insurance coverages, limits, retentions/deductibles, and overall risk tolerance.

The main concern from an insurance perspective as a private equity firm looks to close an acquisition is if the underlying property, casualty, and/or management liability program is not adequate for the anticipated go-forward growth of the company under new ownership. As CFOs look to generate savings on insurance, they may opt to decrease the limit on various policies or remove policies altogether that they deem as lower exposures. As we review the program during due diligence, the goal is to assess the overall adequacy of the program in terms of limit structure and cost. If we uncover the limit structure has changed recently, this raises a potential flag of how the management team is approaching the insurance and risk management of the company. While this may be an acceptable way to approach insurance as a stand-alone, privately held business, a private equity firm will want to ensure the limits are more than adequate for their investment.

For a private equity deal team, this approach means there may be recommendations around limit adequacy or increasing the amount of coverage the company purchases pre- and post-close. This could have an impact (sometimes material) on the total cost of the program, which in turn will affect the adjusted EBITDA post-close.

Trend #5: Take-Privates and Corporate Divestitures Are Gaining Momentum and Have Key Insurance Implications

In its *Q2 2022 US PE Breakdown Report*, Pitchbook predicts "more public companies could reach out to sponsors for defensive capital during market turmoil as they feel pressure to tap the private markets for liquidity instead of continuing to face quarterly reports and analyst scrutiny in a challenging market." There have been 18 take-private deals in the US during the first half of the year, and this number is expected to increase during the latter part of the year and into 2023 as public companies look to boost profits. In addition, we have seen the number of carve-outs/divestitures increase. Like a complete take-private, private sponsors are taking advantage of publicly traded companies (or private strategics) that are looking to divest non-essential or poorer performing business units.

CREATE NEW INSURANCE PLANS WITH MINIMAL DISRUPTION TO EMPLOYEES

The carve-out or take-private transaction structure is unique and challenging from an insurance perspective. This challenge is because a new property, casualty, management liability, employee benefits, and 401(k)/retirement plan must be established for the new stand-alone entity. In most cases, a transition services agreement (TSA) will be put in place at closing for some time, typically 60-90 days. This agreement will typically apply to things such as payroll processing, employee benefits implementation, and 401(k) plans under the existing arrangement.

Most clients indicate one of the key challenges of a carve-out is ensuring there is as little disruption as possible to the individual employees. So, if something can be included in the TSA, it should likely be to ease that disruption. However, a new property, casualty, and management liability program must be implemented on Day 1, as the carve-out is separated from the former parent or publicly traded company.

From a due diligence and pre-closing perspective, the insurance advisor will work on two simultaneous workstreams: (1) Diligence and analysis of the current program to gauge if there are any deficiencies, gaps, benchmarking, run-off considerations, etc.; and (2) Solicitation and implementation of the go-forward program that must be put in place at closing. For a take-private, the management liability due diligence task will be significant, and run-off terms and pricing will be a significant factor for closing.

AN EXPERIENCED INSURANCE ADVISORY TEAM IS ESSENTIAL

Based on our experience, we believe it is critical to work alongside an insurance advisory team that not only has experience working on carve-out or take-private transactions but that uses the same team for both due diligence and servicing the company post-close. With myriad tasks to complete pre-closing as well as TSA requirements for post-closing, there is simply no time for any type of hand-off between a centralized diligence team and a local broker team.

Get Up to Speed with Woodruff Sawyer

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Representations and Warranties Insurance Buying Guide >>

Tax Liability Insurance: The Basics >>

Insurance Due Diligence for Middle Market and De-SPAC Transactions >>

Guide to D&O Insurance for SPAC IPOs (and How to Save Money on Your D&O Insurance Premium) >>

Guide to D&O Insurance for De-SPAC Transactions >>

2023 D&O Insurance Trends: *A Looking Ahead Guide* >>