Private Equity

LOOKING AHEAD TO 2025

Industry Trends, Insurance Due Diligence, and RWI

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Private Equity Market Update

Luke Parsons

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1.1 Turbulent 2022 and 2023 Deal Landscape Continues in 2024, with Signals of (Hopefully) Imminent Improvement

In last year's *Looking Ahead Guide*, we had predicted the 2024 deal landscape would improve over 2023 year-end results in terms of number of closed buyout transactions, transaction values, and exits. This seems to be the case, as we see initial signs of an improving landscape after a stronger Q2.

According to EY's *Private Equity Pulse*, Q2 2024 was the strongest quarter in two years, with 122 announced transactions at a valuation of $196 billion total enterprise value. But the US PE market is still a good distance from the 2021 heights. According to Bain & Company's *Private Equity Midyear Report 2024*, "activity relative to the mountain of dry powder available remains stunted by historical standards. For comparison, 2024 deal value is on track to roughly match 2018's total, yet there is more than 1.5 times as much buyout dry powder today as there was back then."

The report also mentions: "…buyout funds globally are now on track to finish the year essentially flat vs. 2023's count total. While exits also appear to have arrested their freefall, activity has landed at a very low level. And as limited partners (LPs) wait for distributions to pick up, most funds are still struggling to raise fresh capital."

While stable is better than decreasing activity, there is still a long way to go for 2024 deal flow to reach the levels seen in 2021. What the first two quarters of 2024 do suggest is we may be at the bottom of the downturn.

Similar to 2022, 2023, and 1H 2024, US private equity funds appear to still be in a wait-and-see mode. The Fed did cut interest rates by 50 bps, which is a positive sign. With sellers looking to maximize asset value after longer hold periods and buyers unwilling to bear the higher interest rates to purchase those assets, the valuation gap has appeared to be too great for activity to pick up in a meaningful manner. However, with the recent interest rate cut on September 18, 2024, there are signs the Fed is going to be more aggressive than originally thought with regard to rate cuts moving forward. In our experience, many buyers have been on the sidelines and have been waiting to crest the peak of increasing rates. Now that the Fed appears to be on a downward—and somewhat aggressive—slope with cutting rates, we could see positive momentum in the middle-market deal space to end the year.

Even in a tougher deal environment, private equity firms are still managing to put capital to work by keeping deal sizes small, engaging in add-on transactions, or finding alternative sources of capital to finance the transactions.

As we mentioned in last year's *Guide*, we are seeing take-privates and carveouts as viable and prevalent as the leveraged buyout (LBO) market struggles with continued uncertainty. Woodruff Sawyer's private equity team has been involved with several large take-private and carveout transactions in 2024, and we expect this trend to continue in 2025.

Looking forward to Q4 2024 and into 2025, we believe while the deal landscape may continue to evolve and new structures develop, deal flow will increase as compared to 1H 2024.

We also believe the private equity buyers will still be looking for ways to significantly improve each portfolio company operationally to improve EBITDA margins prior to taking the asset to market.

The Importance of Due Diligence and Optimizing Value for Portfolio Companies

What does this macro backdrop mean for private equity firms that are engaged in completing due diligence and seeking to close transactions Q4 2024 and 2025 from an insurance perspective? Simply put, insurance due diligence (including post-close diligence) will continue to be a critical workstream as deal teams and operating professionals seek ways to improve and maximize EBITDA margin and mitigate risk to their investment assets. This plays a role in both the pre-close due diligence, where strategies and efficiencies can be identified and financial impact projected, as well as post-close, when implementation of new strategies take shape.

Insurance and employee benefits 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 of advisors 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 in the lower and core 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 portfolio company level, consistently and incrementally improving the companies' EBITDA margin through insurance and benefits program optimization is critical.

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.

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Insurance Due Diligence Top Trends

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.

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

As deal flow remains below 2021 levels, private equity firms are continuing to put stronger efforts into improving operational efficiencies. With funds holding more assets for longer periods, portfolios are getting larger and there is more time to positively impact EBITDA at an operational level.

As noted in *Pitchbook's 2024 US Private Equity Outlook: Mid-Year Update*, "sponsors continue to employ more of a value-oriented dealmaking approach, and as a result, non-backed businesses continue to account for the majority of PE deal activity in the US. Through the end of Q2 2024, non-backed companies accounted for 56.4% of US PE deal activity, with the first and second quarters of 2024 seeing sequential increases."

> This ongoing trend supports our belief that private equity professionals can increasingly focus on smaller (or larger) incremental ways to improve a company's margins. One of those ways is most certainly the business insurance and employee benefits programs.

As portfolio companies begin evaluating margin improvement opportunities, we expect they will continue to place 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. On the property and casualty side, funds are using insurance advisors to look for ways to improve retention and limit management while maximizing cost savings.

2.2 Trend #2:
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 2024. So far in 2024, we have seen an uptick in add-on acquisitions, take-privates, and corporate carveouts/divestitures as compared to 2023, and growth equity deals continue to be an attractive way to put capital to work. 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, in a take-private transaction, the management liability (directors and officers liability) program coverage structure and cost will completely change. The existing public-company D&O program will be placed into runoff and a new go-forward, private company management liability program will need to be implemented. The limit and retention structure and overall coverage of a public versus private company management liability program can vary significantly, and runoff terms/conditions and pricing can be renegotiated prior to closing. This could impact the cash flows of the company at closing by hundreds of thousands, if not millions, of dollars.

In a take-private transaction, it is critical to engage a specialist insurance advisor who works directly in the private equity space and who can work on the necessary tail coverages while simultaneously structuring a go-forward management liability program that is appropriate for the go-forward entity under PE ownership. They must also be able to perform due diligence on the other property, casualty, and employee benefits coverages.

As another example, in an asset or carve-out transaction, an entirely new property, casualty, and management liability program will need to be implemented at close. Depending on the nature of the transaction structure, the diligence strategy and go-forward implementation can vary widely. It's critical to engage an insurance advisor early and often in these processes to ensure nothing is overlooked.

Although we expect the deal landscape for LBOs to improve in Q4 2024 and throughout 2025, 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 >>

2.3 Trend #3:
The RWI Market Continues to Be Extremely Competitive in 2024

The representations and warranties (RWI) marketplace continues to see high levels of competition in 2024. We continue to have new entrants, which indicates the expectation for continued M&A growth. We expect it will continue throughout 2025 as deal flow gains steam again.

Despite the uptick in activity, pricing and retention remain at market-low levels. In Q4 2023, a $100 million deal may have received between 10 and 15 quotes. In Q3 2024, that same transaction likely received just as many quotes and as low a retention and rate. Private equity firms can expect low rates and retentions in Q4 2024 and into Q1 2025, as well as broadened terms and conditions.

This competitive landscape may shift slightly throughout 2025 as deal flow increases, but we expect it to remain steady due to increased capital and new entrants in the market.

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Transactional Insurance Market Update

Emily Maier, Stacey Hammer, and Tyson Freeburg

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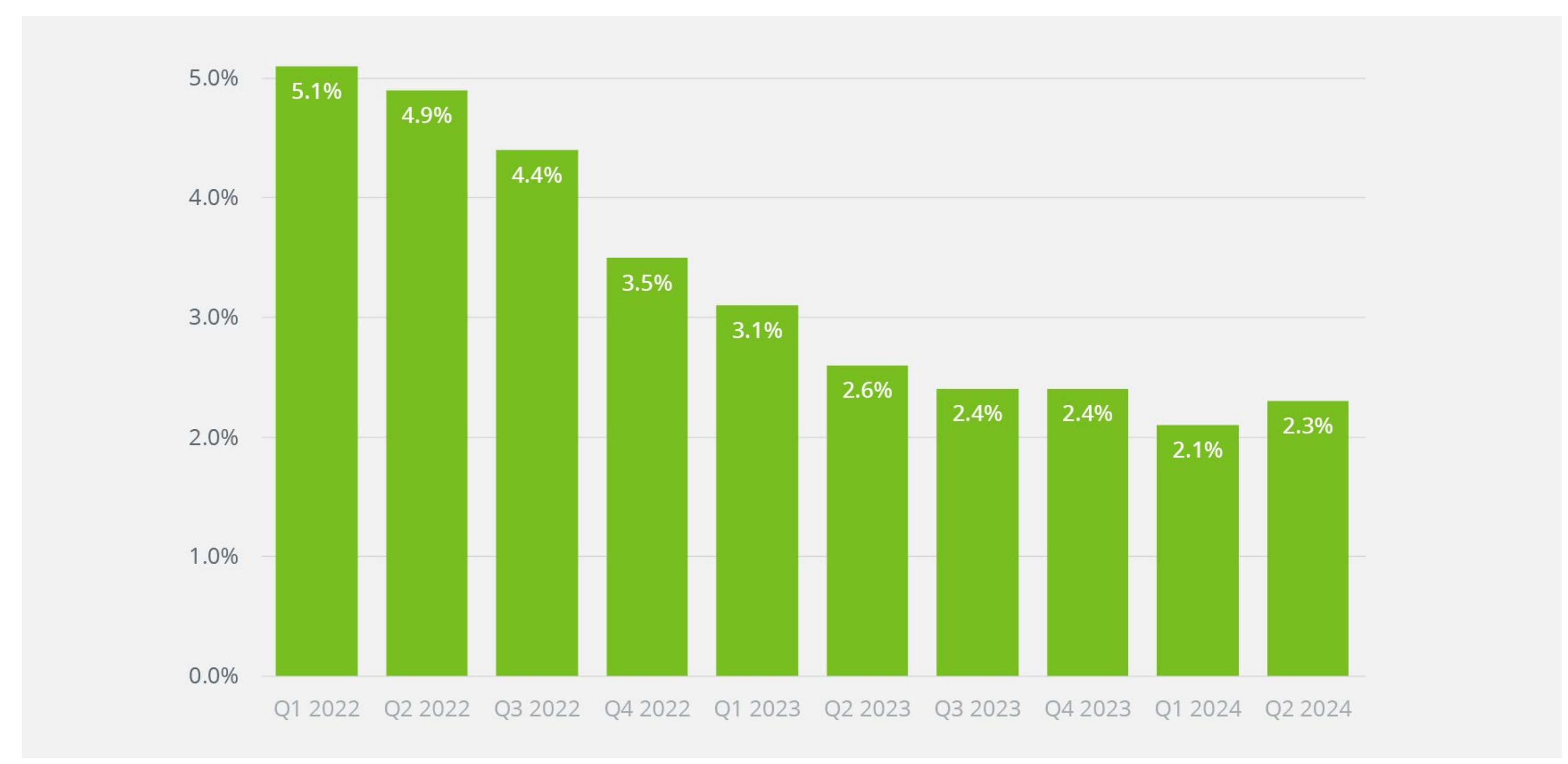
3.1 Fierce Competition Lowers Rates

The RWI 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 1.9%–2.5%. 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 Percentage of Limit by Inception Quarter for Bound Policies



Source: Woodruff Sawyer

What does this pricing trend mean for M&A insurance buyers? It's a good time to get 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 2024, 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 about 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 to get terms for limits as low as $3 million—while keeping the same rate as larger deals.

Reps & Warranties Insurance: Our 2024 Guide >>

RWI is now an established component of the M&A toolbox. Get trends in this growing marketplace as well as insight and analysis.

4.0

Transactional Insurance Top Trends

The underwriting market continues to grow, maintaining 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.

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4.1 Trend #1: Use of RWI in Secondaries Continues

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 have seen a substantial growth in market appetite for secondaries, and most will now offer coverage for excluded obligations.

Insurance Coverage for Secondaries: Market Trends >>

Read the latest market trends about the growing use of private equity secondaries transactions.

4.2 Trend #2: Further Price Drops May Be Unsustainable

The market continues to be highly competitive. While we thought pricing couldn't drop much more this year, it has, with offers of lower than 2% coming regularly.

4.3 Trend #3: Retentions Drop to New Lows

Downward pressure is still being applied to retentions as well. Last year we were seeing 0.5%, but those retentions didn't always drop after 12 months. Now we see 0.5%, with a drop as low as 0.1% after 12 months. Zero retention on true fundamentals is now the standard, rather than the new idea it was in 2023.

4.4 Trend #4: Claims Activity Rises

We have seen an uptick in claims activity, which is a standard phenomenon across all insurance lines in a downturned economy. We anticipated this would cause more dissatisfaction with claims handling because insureds are making more speculative claims attempts. This has created an almost two-tier system for claims in RWI. Some have started to push back on legitimate claims over small technicalities, while others continue to be positive in handling claims. We expect this will have a real impact on how clients choose an underwriter.

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About Woodruff Sawyer

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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

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