THE IMPACT OF PRIVATE EQUITY OWNERSHIP ON RISK MANAGEMENT

An in-depth survey of portfolio company risk management

MARSH

RISK AND RETURN

Private equity managers generate their returns by bringing and managing change to the companies they invest in, ultimately to enhance value. In many cases such change will impact a company's risk profile – sometimes quite considerably. Through a survey of 50 C-suite executives from UK-based private equity-backed companies, we set out to determine how attitudes towards risk management may change at a portfolio company level following private equity investment and to ask the question: what role, if any, does the private equity manager play in this?

COMMENT

Expert comments on the survey's findings have been provided by global risk management and insurance provider, Marsh, who sponsored this report. Marsh is a recognised global leader in risk and insurance advice to the private equity industry providing transaction and placement services to private equity firms and their portfolio companies.

THE SAMPLE

We surveyed 50 C-suite executives from private equity-backed companies, including CEOs, CFOs and COOs. Our respondents were seasoned private equity-backed managers, with the vast majority having worked with more than one backer and over 50% with three or more.

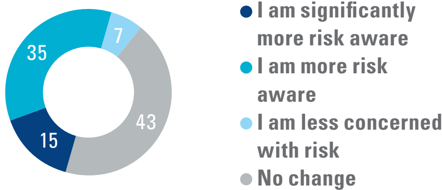
Businesses with an enterprise value of less than £100m represented 64% of respondents; 13% were from enterprises valued at between £100m and £250m; 9% in the upper mid-market space of £250m-£500m; and 9% at the larger end of the spectrum at £500m+.

All data is expressed as a percentage.

Section 1

IMPACT OF PRIVATE EQUITY OWNERSHIP ON APPROACH TO RISK

Q How has your attitude towards risk changed since your company became private equity-backed?



The risk profile of a business can evolve considerably over time following private equity investment as a company strategy changes, for example to target new products, new services, new geographies, bolt-on acquisitions and ultimately increased growth rates. In addition, many businesses undergo operational and/or financial restructuring under private equity ownership and this can increase or reduce risk in parts of the business or across the company as a whole. This would suggest that private equity investment should prompt a more rigorous approach to reviewing risk.

Yet when we asked respondents to our survey how their attitude to risk had changed following private equity investment, the answers were mixed. Half said they had become more risk-aware following private equity investment, particularly as the nature and extent of risk changes as backers bring additional finance – and expectations – to and of the company. One respondent commented: "Private equity brings higher, more aggressive risk because backers are looking to sell the business in a specified amount of time – that means they have to generate their returns relatively quickly. However, longer term risks are less of an issue for private equity."

Many commented that they felt able to take more risk following private equity investment. "As a business, we are more inclined to take calculated risks with a sponsor on board – there is pressure to grow," said one respondent. Another said: "Private equity backing is more likely to make me less risk averse because the funding is there and decisions can be made quickly."

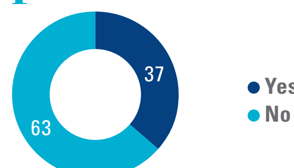
A significant number of respondents (43%) said there was no change. The general sentiment here was that the board already took care of risk management in a professional manner and so, beyond having to report to backers, little had changed.

"As an owner-managed business, you might take a course of action that involves an element of risk but where the value creation may be less obvious," commented one. "However, with a private equity backer, you can't rely on gut feel, you have to take decisions based on return on investment. Nevertheless, our attitude towards levels of risk hasn't really changed as we have always been focused on it and have sought to de-risk as much as possible."

A small minority (7%) said they were less concerned with risk, while none said they were significantly less concerned.

Marsh Comment: It is acknowledged that management teams will already be focused on risk prior to private equity investment. However, the results show that many are not prompted by the investment to re-visit their approach to risk. A change in ownership structure and strategic direction should maybe prompt a more formal or balanced approach to risk management than the company may have had historically.

Q Did a formal review of your risk exposures form part of your current private equity owner's 100-day plan?



When asked whether a formal review of the company's risk exposures was part of their backer's 100-day plan, over a third (37%) said yes, although it should be noted that a number of respondents were unable to answer this question as their private equity owner did not put a 100-day plan in place.

Marsh Comment: In Marsh's experience, it is relatively rare for specific items relating to the management of risk exposures to appear on a 100-day plan unless they are considered critical by the private equity investor. Despite this, less critical areas for review and/or improvement may have been raised during pre-acquisition due diligence prompting follow up outside of the 100-day plan.

Q How involved is your private equity owner in managing risk within your business?

Over the last few years, many private equity firms have sought to build out their teams so they can be more operationally-focused in their approach to adding value to portfolio companies. However, our results suggest that this increase in operational focus does not extend to risk management. Half of our respondents (51%) said that their private equity backer left risk management to the company management, while a further 32% said private equity left risk protocols to management but insisted the company had a risk management framework. Many felt this hands-off approach to risk management was appropriate as they said management was capable of forming risk management protocols. They also said that this area was not part of private equity's core skill set.

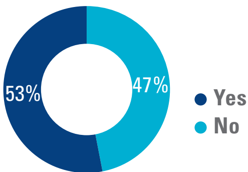
"You'd expect the executive management, together with the non-executive directors to take care of operational risk," said one respondent. "The private equity owner wants to do deals, not operational stuff, and risk falls clearly into the operational category."

Another said: "My experience of working with four different private equity backers is that they are typically hands-off when it comes to risk management," he said. "I've never had a directive to carry out any specific risk assessment. They do of course demand 'adequate' insurance cover but leave the judgment of 'adequate'

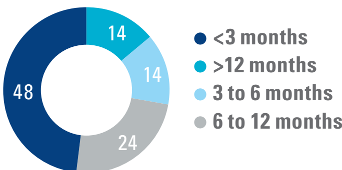
to management."

In 2% of cases, the private equity manager mandates risk protocols, and 15% said the private equity owners get actively involved in risk management protocols.

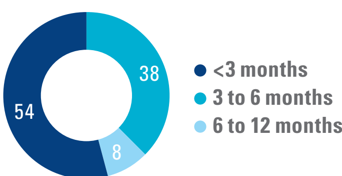
Q Do you have a formal risk register or risk inventory? If yes, please specify the last time this was reviewed at each of the following levels.



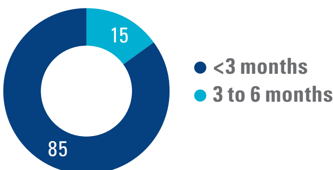
Q If yes, please specify the last time this was reviewed at board level



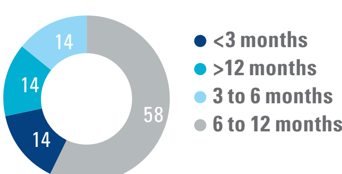
Q If yes, please specify the last time this was reviewed at business unit level



Q If yes, please specify the last time this was reviewed at in-house risk level



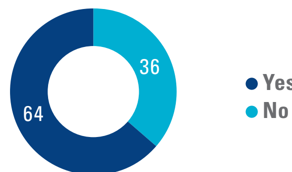
Q If yes, please specify the last time this was reviewed by an external adviser



Over half of respondents (53%) said they had a formal risk register or inventory, with most reviewing it every three months at board level, business unit level and/or using a designated in-house risk co-ordinator. Where external advisers are used, they tend to be brought in every six to 12 months to review (those disclosed were either accountants or insurance brokers). This type of formal approach to risk management appears to be of high value to these respondents as the results suggest they are actively monitoring the register. Among those that do not currently have such a register, a number said they were in the process of putting one together following private equity involvement – suggesting private equity firms are proactive on ensuring there is a formal procedure to identify the risks faced in their portfolio companies.

Marsh Comment: We agree that formal risk registers are an important part of the risk management toolkit, but only if they are seen as dynamic documents. The understanding of the term 'risk register' can vary widely. In our view, effective risk registers are built around the principal risks that can affect the business's strategic objectives, with these risks prioritised and – importantly – quantified. This formal document is then regularly reviewed, monitored and updated by the senior management team.

Q Do you have a formal business continuity plan?



Our survey found that 64% of respondents had a formal business continuity plan. Among the remaining 36% that did not, respondents commented that they felt a less formal approach was appropriate. "We are not large enough to have a formal plan, but we use a combination of finance and HR activity around what might happen in the event of a disaster," said one.

Marsh Comment: It is clear that the majority of respondents to the survey felt a business continuity plan was an important element in managing risk. However, in our experience, the focus is often on physical assets, with some companies even focusing on IT disaster recovery in isolation. This may leave other critical areas unaccounted for, such as supply chain issues. The collapse of a factory in Bangladesh, the horsemeat scandal and the Japanese tsunami all caused major disruptions to supplies and had reputational ramifications.

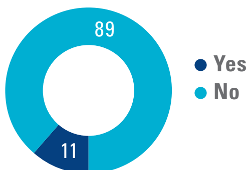
In addition, through our work with portfolio companies, we have found that many do not make an effective link between business continuity planning as part of an overall risk management strategy and a company's business interruption insurance protection, leaving some seriously exposed to the risks they face. The two should go hand-in-hand – by understanding the risks and associated scenarios a company faces and formulating how to respond to particular events, management can be more focused in their insurance procurement strategy.

Section 2

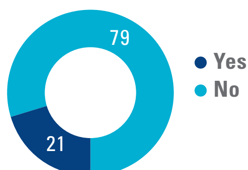
IMPACT OF PRIVATE EQUITY OWNERSHIP ON APPROACH TO INSURANCE PURCHASE

Q Has your company's insurance programme changed significantly following: 1) A formal risk review process, 2) The latest buy-out?

Q 1) A formal risk review process



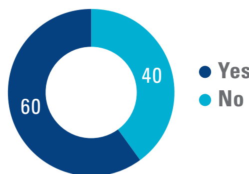
Q 2) The latest buy-out



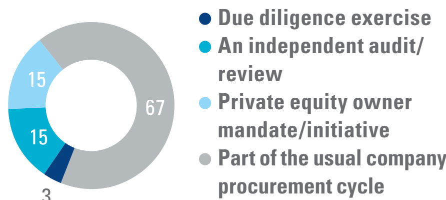
As we've noted, private equity investment often brings with it significant change leading to a company's risk profile evolving over time. For a company's insurance programme to remain optimal, there is a need to more regularly review risk exposures and other forms of risk mitigation as part of a company's overall risk management strategy. However, our survey found that just 11% of respondents had changed their insurance programmes following a formal review and 21% following the latest buy-out. One respondent commented: "The risks would largely have been covered in our business before private equity ownership. We have always ensured we have adequate cover for assets or business interruption cover. Insurance in my view is more about disaster recovery."

Marsh Comment: This suggests that many private equity-backed companies may not be undertaking an in-depth review of their risk exposures following private equity investment, including consideration of future changes/growth that may alter their approach to risk and insurance.

Q Have you held a review of your external risk and insurance provider since the most recent buy-out of your company and, if so, what triggered such a review?



Q If yes, what was the primary driver for undertaking this review:



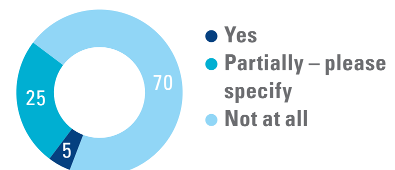
The majority of respondents (60%) said they had undertaken a review of their external risk and insurance provider since the most recent buy-out of their company. Nevertheless, private equity initiated such reviews in just 15% of cases. The most usual trigger for such a review was the company's usual procurement processes, cited by two-thirds of respondents.

Marsh Comment: Private equity ownership brings with it certain changes that should be reflected in a company's risk and insurance strategy, for example:

- A standard off-the-shelf directors and officers liability policy will not be appropriate for a company with majority private equity ownership. Only a specifically tailored solution will offer the protection needed.
- If a private equity firm chooses to follow a 'buy and build' strategy (including acquisitions in new territories), not only will a company need to review the adaptability of their current insurance programme, it will also decide whether its incumbent insurers have the global reach and capability to cater for this.

Also, not all providers (risk and insurance brokers) have the necessary knowledge and experience to provide appropriate advice and ongoing support to management. This is particularly the case where transactional services such as due diligence and/or warranty and indemnity insurance solutions may be required in relation to future bolt-on acquisitions, mergers or divestments. We would suggest that private equity investment is a trigger for a review, regardless of whether this corresponds with a company's usual procurement process.

Q Is your private equity owner actively involved in the design and scope of the company's insurance programme?



Private equity backers generally leave insurance matters to company management, our survey found. Just 5% of respondents said that their private equity investor had been actively involved in the design and scope of their company's insurance programme, with a further 25% saying they had been partially involved with

initiatives such as support with directors and officers liability (D&O) cover and providing an outside consultant to work with the FD at renewal cited by some.

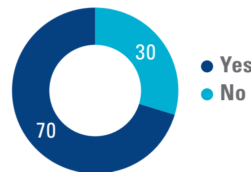
However, nearly three quarters said their private equity backer had not been involved at all. For some respondents, the hands-off approach was considered entirely appropriate. "This is left to management," said one. "I'd be alarmed if private equity became involved." Another agreed: "Insurance is an operational item. I'd expect private equity to defer to management on this provided the company was using a broker."

However, some respondents felt that private equity could be more involved, particularly in newer, entrepreneur-led businesses as part of a broader process of professionalising the company. "Private equity can help younger companies put in place more formal recording and discussion of risk," said one. "They can help ensure the right insurance is in place and help identify what could cause significant interruption – this kind of thing is often inside founders' heads rather than laid out for all to see. If you want to double the size of your business, this is vital."

Another commented: "When I came to the business, the risk insurance was covered separately in each country. I brought in an adviser to put in place a global risk policy and saved £100K in the process. Our backer wasn't at all interested, although they were impressed with the saving. They ought to have been more aware of the insurance programme."

Marsh Comment: While we would agree that risk and insurance is an operational item and the responsibility of management, in our experience private equity firms are increasingly interested in certain aspects, such as ensuring appropriate D&O insurance is in place as referenced above.
In addition, some private equity firms are choosing a preferred risk and insurance provider to aggregate and leverage the insurance spend across their portfolios. This type of approach delivers cost reduction to the individual portfolio companies but also an increased focus on risk exposures, enhancing insurance protection and providing consistent 'best in class' service and solutions.

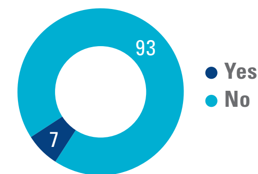
Q Does your company purchase D&O liability insurance that has been specifically tailored to reflect your private equity ownership structure?



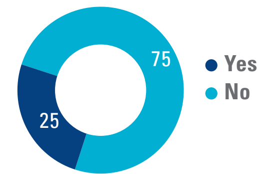
D&O cover is clearly important in private equity-backed companies. Nearly three-quarters (70%) of respondents said they had such cover in place that was specifically tailored to reflect their private equity ownership. However, private equity's involvement in designing such cover may be limited in some instances. "I'm not sure whether, at inception, private equity reads through D&O cover, although they will have read the insurance due diligence," said one respondent.

Marsh Comment: As referenced earlier, it is essential that a portfolio company has tailored D&O cover that reflects its specific circumstances and requirements. The reality is that insurers will apply their standard 'off the shelf' D&O policy wording unless the insurance broker highlights the need for a tailored solution and outlines the amendments/extensions in cover required. For example, ensuring a major shareholder exclusion is not applied. Understanding the requirements is key to ensuring appropriate protection for the personal liability (and assets) of directors.

Q Have you made any business interruption claims in your career while being private equity- backed? If yes, did you recover 100% of your loss?

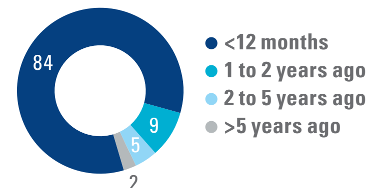


Q If yes, did you recover 100% of your loss?



The vast majority of respondents had not had cause to make a claim on this type of insurance (over 90%). However, of those that needed to, three-quarters had been unable to recover their loss in full, suggesting they did not have appropriate cover in place. This underlines the importance of regular risk reviews to ensure insurance coverage is adapted, not only to reflect a company's changing exposures, but also so that relevant risk management strategies (e.g. business continuity plans) are kept updated.

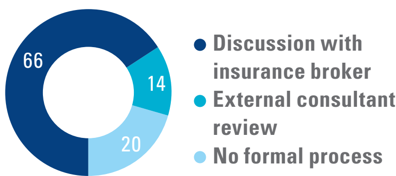
Q When did you last review your business interruption insurance?



The importance of business interruption insurance to portfolio companies is reflected in the fact that 84% of respondents had reviewed this in the last 12 months. 9% stated they had reviewed this between one and two years ago, and 7% more than two years ago. Interestingly, some stated this had not been reviewed for over five years.

Marsh Comment: The risk of business interruption is faced by all companies, private equity-owned or not. However, private equity ownership brings an increased need to ensure the business is appropriately protected with no major gaps in cover or uninsured areas that may impact the investment. Business interruption claims can be costly. This class of insurance is a complex area, highlighting the need for the right advice from your insurance provider.

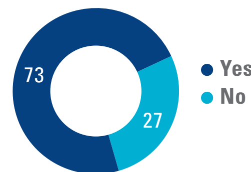
Q What processes have you undertaken to ensure you have the right level of business interruption insurance?



Two-thirds of respondents used insurance brokers to ensure they had the right level of cover, but a fifth said they did not use any formal process. Just 14% use an external consultant review.

Marsh Comment: A review of this type of insurance should go beyond a high-level look at the current basis of cover, sum insured/limit and indemnity period for the purposes of providing renewal information to insurers. Ideally, more detailed analysis should be undertaken, with consideration given to risk mitigation measures that may be in place, such as business continuity plans, to fully understand the exposures. Some insurance brokers and insurance companies offer support through in-house risk consultants who specialise in this area of risk.

Q Do you know what your debt covenants say with regards to the company's asset and business interruption insurance?



Nearly three-quarters (73%) are aware of what their debt covenants say with regard to their company's asset and business interruption insurance.

Marsh Comment: This is an important area and particularly relevant if you are considering reducing the level of business interruption insurance you purchase, to ensure you do not breach covenants. While you may feel that you have robust risk management strategies in place to support this, lenders often take a more cautious approach seeking the widest possible insurance protection.

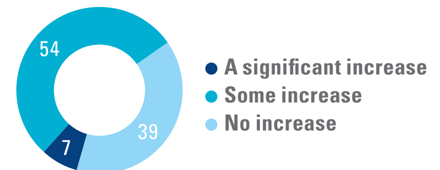
Section 3

PREPARING FOR EXIT

Q Are you currently preparing for exit?

A future exit/sale process is a certainty for all private equity-owned companies and will likely involve new and different risks that need to be identified and adequately managed. Most respondents were not currently preparing for exit, although 41% were either in the active or preparatory stage. Selling the company to a trade buyer was the most likely exit route for the majority of our respondents (54%). A sale to another private equity firm was the expected outcome for 26%, with the remainder seeking an exit via the public markets.

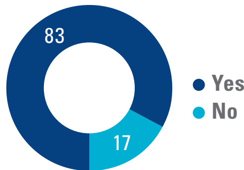
Q Are you experiencing, or do you expect to see, an increase in risk management activity in preparation for exit?



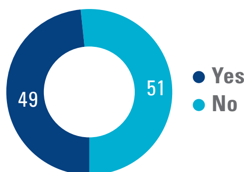
Portfolio company management needs to recognise the risks that a potential sale can bring to their business. The identification of risks that might be uncovered by potential buyers, the repercussions of a failed sale process, the need to offer warranties and indemnities as well as the issue of key decision-makers being too preoccupied with the exit to devote adequate time to the business are all possible risks that management need to consider. In our survey, just over 60% of respondents said they anticipated or were experiencing an increase in risk management activity in preparation for exit. However, 39% said there would be no increase. Some commented that the risks had already been covered before; others said this was being taken care of by the private equity owner.

Marsh Comment: Just as we see companies focus on organising their legal, financial and tax affairs prior to embarking on an exit process, so we see opportunity for them to look at risk and give consideration as to how potential buyers may view the profile of their potential acquisition. Thinking about how the business can 'clean house' from a risk and insurance perspective can not only facilitate the process but, in extreme cases, assist with supporting an aspirational valuation. We see this whether it may be an exit through the public markets or in an off-market transaction and can manifest in a number of ways – from ensuring the target's insurance programme is fully documented and comprehensive with regard to past liabilities, through to how to use insurance to manage transactional risk allocation at point of sale (through warranties/indemnities).

Q Do you expect that vendor due diligence will be conducted in preparation for the exit?



Q If yes, do you expect a specific risk management/insurance report will be prepared for prospective purchasers?

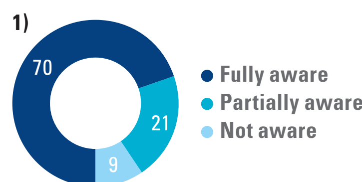


Vendor due diligence is an important tool in helping to mitigate the risk of failed sales processes, and it seems that this has now become an accepted part of the exit process. Over 80% said they expected this type of report to be prepared. Nevertheless, our survey suggests that an important part of vendor due diligence may be being overlooked. Just less than half (49%) of those preparing vendor due diligence expected risk management and insurance to be prepared for potential acquirers.

Marsh Comment: In our experience, vendor insurance due diligence is more commonly used by companies with complex risk and insurance programmes, e.g. those with global operations, in a particularly high-risk sector or with a captive/high levels of self-insured retention. Equally, companies looking to divest a part of their business may be more likely to focus on this to highlight separation considerations. Key drivers for use include helping to avoid the potential for purchase price disputes, as well as minimising the likelihood of issues arising after completion.
That does not mean that vendor insurance due diligence may not be useful to other companies, particularly where they are running an auction process and wish to provide bidders with the information necessary for them to bid with confidence. This may also increase the speed of a sale by avoiding buyers asking the same questions.

Q 1) Are you aware of the type and scope of any warranties and indemnities (W&I) that may be required to be given on exit? And 2) is insurance cover to W&I likely to be considered as part of the exit?

1)



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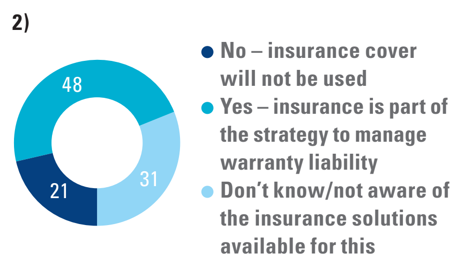

The exit phase of a private equity investment clearly brings a new dimension to the risks faced by directors. Most (70%) are fully aware of W&Is that they might need to give on exit, with a further 21% partially aware. Nevertheless, nearly a third of respondents were unaware of the insurance solutions available for this, and a further 21% said they would not be using it. "W&Is are very much guided by the transaction itself and the nature of the buyer" said one respondent. "The key is to plan well in advance to ensure you are compliant – and by that I mean you have to check legal compliance as well as undertaking contractual reviews across the board."

There was some scepticism among respondents around whether insurance would actually help cover directors in the event of a claim, and many felt that it was up to management to ensure that the business is what they claim it to be. "W&Is are a key item for management on exit," said a respondent. "You have to ensure you have the right wording on clauses, especially if you are selling to a US buyer where indemnities are especially important. However, we wouldn't take out insurance for this as it is very much management's responsibility and I don't believe you can cover this."

Marsh Comment: These results suggest a misunderstanding by portfolio company executives as to how insurance can be, and is being, used around warranties and indemnities.
Increasingly, it is being used to enhance the recourse available to the buyer. This relieves the selling shareholders – both institutional and directors/executive management – from substantial long tail liability and releases cash proceeds. We have seen a 150% rise in its use in 2014, and a large amount of this is driven by private equity exit scenarios.

CONCLUSION

As we've noted, private equity backing brings with it significant change at a portfolio company. While many companies, prior to private equity ownership, do focus on risk management, it's clear from our survey that few consider the altered nature and scope of risk that comes with having an outside investor on board and with new growth strategies that may involve entering new territories, product and service lines, a different capital structure and, in some cases, a restructuring or streamlining of the business.

Private equity firms have a role in supporting their portfolio companies in this regard. In addition to helping build a framework through which risk can be identified, managed and actively monitored, they are also well placed to assist companies in ensuring they have access to the right advice and therefore have tailored insurance cover that meets their needs, mitigates the specific risks faced by private equity-backed company directors and offers protection in the event of problems that occur outside the business's control. Private equity firms can also help companies reduce the overall cost of their insurance by aggregating spend across the portfolio.

Overall, a holistic approach to risk management and mitigation, with formal procedures and documentation, together with the right insurance products and cover, can add value to portfolio companies and help ensure maximum valuations are reached at the point of exit – and that is to the benefit of management, employees and backer alike.