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No easy route: D&O risks in a private equity down market

Mike Parry • July 20, 2023

Following the bank of England’s 13th consecutive rate rise, highly UK leveraged companies are further exposed to the effects of higher borrowing costs. The rising cost-of-capital, combined with an inflation environment which has been proven to be resilient to rate hikes, has led to a dampening in valuation of portfolio companies and a tough environment for fundraising. For the Private Equity (PE) community, this creates new pressure to find opportunities at meaningful returns measured against historic expectations. Fund managers are having to take on more proactive roles in their portfolio companies, sometimes stepping into active Director roles in their portfolios, exposing them to greater Directors & Officers (D&O) liabilities and the need to ensure appropriate insurance cover is in place to address them.

After the private company valuation boom during Covid-19, private markets lost momentum and fundraising dropped by 11% to $1.2 trillion in the second half of 2022. Portfolio value decreases affected some limited partners’ ability to allocate capital. Similarly, UK venture capital investment deals fell by 7% in 2022, with the total investment value declining 11% to £16.7bn. These conditions are creating a challenging environment for portfolio managers as they navigate a period where exits via IPO, DeSPAC and M&A are harder to achieve.

Consequently, PE companies are having to take a more active approach to portfolio company management. Fund managers are now increasingly ‘rolling their sleeves up’ and becoming involved in the day-to-day running of companies they have invested in. As dealmaking activity slows, some PE companies are also using ‘dry powder’ – cash that has been committed by investors but not yet allocated to a specific investment – to support their existing portfolio companies during a challenging trading period. We are also seeing more PE companies place members on portfolio company boards to keep a closer eye on whether results are tracking against investment, or to intervene if they are not.

The pandemic boom elevated investor expectations for positive returns in some segments. Yet, data shows that global PE performance turned negative for the first time since 2008 in September 2022, posting a -9% return during the month. There is a gap between investor expectations and the reality of a declining valuation market.

The down market puts D&O in the spotlight

PE company declining valuations present a number of risks for D&O's – and their insurance providers – to consider. From allegations of financial mismanagement, wrongful trading, to questions over decisions favouring the PE company's interests over that of the company itself, PE companies may require greater support as the economy approaches potential recession.

Due diligence is even more important for portfolio managers and investors in an inflationary environment, especially when PE companies commit to new investments. If companies fail to reach their valuation at exit, investors will query whether directors took the necessary steps to protect their investments. Ultimately, investors who feel insufficient or inappropriate action was taken could take aim at a broad range of management, leading to costly litigation and settlement fees.

Furthermore, as PE companies become increasingly hands-on in the running of portfolio companies, portfolio managers risk being accused of mismanagement. Whilst a more active approach can deliver better results and improve the running of portfolio companies, this isn't guaranteed. Funds which are perceived to be failing in their duty to protect their investors' money could be vulnerable to a claim.

Similarly, a more active role in a portfolio company is likely to lead to decisions which impact its staff. If that means reducing headcount, a PE company could find itself facing employment claims.

The down market is also creating challenges for investing in and exiting businesses. Whilst the deal market remains flat, exit options are reduced and opportunities to invest in companies are limited. If this were to impact a fund portfolio's overall performance, investor confidence in fund managers could plummet and lead to claims around mismanagement of investor funds.

As we continue to see a period of increased scrutiny, PE managers are experiencing challenges that go beyond tough market conditions. Specialist protection against potential liability is essential for PE companies looking to mitigate the risks associated with a down market. Insurance is one way fund managers can manage and mitigate D&O risks.

Beazley's new PE Portfolio D&O product provides cover or options to quote for all eventualities, from the first purchase of the asset to the ultimate exit strategy. Policyholders also benefit from a free legal helpline to help navigate the risks outlined above and those throughout the private equity lifecycle.

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