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D&O Insight: Private Equity Risk in 2024

Hugo Rivera • March 19, 2024

After a difficult couple of years, private equity activity is set to rebound in 2024. However, issues such as high interest rates, inflation, and margin compression caused by costs rising more quickly than revenues, mean the industry is set to continue to look very different from the one that existed before COVID-19.

One recent trend, for example, has been towards more bolt-on acquisitions within portfolio companies. Many buyout firms are now focusing to a greater extent on mergers and acquisitions (M&A) activity at their businesses because exits are more challenging in the current economic environment. The idea is for them to be able to reap the benefit of cost synergies, and - ultimately - increase the value of their investments. In addition, longer investment-hold periods are likely, as funds seek to boost their revenues.

Some trends haven't changed, however. Technology remains private equity's biggest source of deal flow. According to a report from EY in January, the sector accounted for more than 30% of total deal value in 2023, more than double the percentage of any other sector[1].

An uncertain road ahead

Looking ahead, high interest rates are likely to continue to hamper firms' abilities to both purchase assets and command an acceptable valuation for them on exit. Meanwhile, they face the same price pressures as other businesses, whether in areas such as raw materials or labor shortages, which are also likely to remain an issue.

In addition, the regulatory landscape continues to shift. An increasing focus on Environmental, Social and Governance (ESG) issues from investors and regulators means firms will need to have robust processes in place to ensure their companies stand up to the enhanced regulatory scrutiny they will attract.

Focus on what you can control, not on what you can't

Mitigating these risks will lead to new challenges for private equity firms, but also new opportunities. To bolster revenues in what is likely to continue to be a challenging economic environment, private equity firms will be expected to focus even more on improving their portfolio companies' management teams, to generate the returns their investors require and keep their funding pipelines open. This will entail them understanding in even greater depth the whole spectrum of their companies' operations, as well as where the risks lie. There will also be a greater emphasis on improving talent management at the companies they own, to ensure they attract and retain staff of sufficient quality.

In addition, there is likely to be an increased focus on revamping Human Resources departments to help manage costs and maximize efficiencies. And it is anticipated that greater flexibility will be required when it comes to deploying capital, such as undertaking minority investments or all-equity deals.

Understand where the risk lies

Private equity firms will hope that building their portfolio companies, reducing costs, maximizing efficiencies, and investing in people and processes will pay off through higher valuations and greater attractiveness to prospective buyers. Doing so will, however, bring them into direct contact with new kinds of risk that they have not had to face before. D&O insurers will want to understand how buyout firms are adapting to this new world when assessing cover.

Greater M&A activity, for example, brings risks in terms of the need to conduct robust due diligence, as well as executing a clear plan for building value so that the acquisition pays off. These changing strategies will increasingly expose private equity firms to claims brought by creditors for breaching covenants or taking money out of the business for their gain. Some private equity firms do not always complete all the necessary due diligence, especially on smaller transactions.

In such an environment, it is critical that firms, or their portfolio companies, work with an insurer partner with a deep understanding of the private equity sector, and which has experience working with private equity groups of different sizes. They should look for an insurance partner that is proactive, flexible, and solutions-driven and able to offer bespoke enhancements not readily seen in the marketplace. Their insurer needs to have a risk appetite that includes writing both runoff and go-forward policies, since each of these may be appropriate at different stages of a transaction, as well as providing direct access to claims teams that encourage in-person or virtual meetings that can be established at short notice. By working with an insurance partner such as this, buyout firms and their portfolio companies can face the future with the confidence that comprehensive D&O insurance can provide, despite the prevailing economic climate.

[1] Witte, Pete. January 11, 2024. EY. "Private Equity Pulse: key takeaways from Q2 2023".

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