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Q&A

M&A RISKS are multiplying

Increased investment puts focus on protecting deals' value

Andy Peterson | Head of Private Equity for Zurich Global Corporate in North America

Private equity investors are pursuing opportunities across virtually all sectors, which is a good sign for economic growth. But along with the increased merger and acquisition activity is a growing set of risks that must be evaluated and managed, notes Andy Peterson, Head of Private Equity for Zurich Global Corporate in North America.

BI: What M&A trends is Zurich seeing, especially involving private equity investment?

Peterson: We are watching several trends when it comes to mergers and acquisitions. One is that fundraising is up over the last several years. Private equity investors are considering opportunities in nearly every sector, including energy, technology, real estate, hospitality and manufacturing, just to name a few. Unlike in past years, no single sector is getting a dominant proportion of funding, and mega-deals are being complemented by smaller transactions. Another trend that we see continuing is longer hold periods by investors to realize value beyond a traditional three- to five-year period. Assets are now being held on average for 10 years plus before an exit. A third trend is expansion of global investment, with sovereign wealth funds very attracted to opportunities in North America right now. Regulation has always been a driver of risk for investors, and a trend we're witnessing now is an increasing number of examinations and enforcement actions by regulators focused on proper disclosure of fees and expense allocations to investors. Additionally, there is regulatory guidance that seeks to limit the use of leverage (or borrowed money). We are also watching growth in secondary markets, as pension funds and endowments look to diversify their portfolios. Finally, we are keeping our eye on interest rates, anticipating that the Fed will eventually raise rates. Record low interest rates and readily available debt have allowed struggling companies to refinance and keep interest payments under control. If interest rates go up, some additional private equity opportunities may emerge in energy, for example, as energy companies face more challenges of a rising cost of capital to go along with a drop in the value of their assets as the price of oil remains low.

BI: With so many different facets to deals, what are some pitfalls to avoid?

Peterson: One common pitfall in M&A relates back to the growing trend in regulatory scrutiny and Securities and Exchange Commission enforcement actions. That pitfall is not giving enough attention to compliance. Private equity firms need to make compliance a priority as it will save countless hours and days remediating a problem and taking the focus off why private equity is in business. Specifically, private equity firms should evaluate their fee and expense allocation policy regularly to ensure that they are adhering to regulatory and investor expectations. No one wants a surprise that could derail a transaction.

BI: What are some of the key risks to consider that can delay or terminate a transaction?

Peterson: The risks that could delay or force the parties to terminate a transaction tend to fall into five major categories: strategic, financial, operational, people and market risks. Examples of strategic risks include an ineffective or ill-conceived strategic plan for the deal, or the lack of a crisis management plan. Financial risks can include poor fiscal management, excess leverage, or exposure to currency fluctuation due to political or trade credit risks. Operational risks are associated with ongoing operations and can include data breaches, the significant loss of corporate reputation or the lack of a business continuity plan. The inability to attract and retain the right people and board leadership is a form of people risk. Finally, market risks include competition, geographic concentration of risks and trade barriers. Any one of these categories could ultimately derail a deal, so it's important to be aware of all of them and take steps to mitigate or protect exposures in these areas.

BI: How has Zurich helped customers address such concerns?

Peterson: Our mission at Zurich is to help our customers understand and protect themselves from risk. We listen to their needs first, and then we address those needs. Some of the many solutions we offer to address M&A risks include transaction liability insurance. These specialized coverages include representations and warranties insurance, tax insurance, and contingent liability insurance. Reps and warranties covers the seller's indemnification for breach of contract, and can protect either the seller or buyer, but about 80% of such policies are purchased to protect buyers. This form of coverage is no longer thought of as discretionary in a transaction; we're seeing customers view it as more compulsory. Tax insurance helps our customers eliminate ambiguity in regard to tax obligations or tax credits, which are common in public works deals. Certain assumptions regarding tax positions are necessary in valuing a deal, and there can be uncertainty around tax, so the tax solution is definitely helpful. Contingent liability coverage is broader and is intended to protect against extraordinary events that can hamper a deal. Contingent liability triggers are specific to individual transactions, so these are written on a manuscript basis. The intrinsic uniqueness of M&A transactions is not a significant challenge for Zurich because we're customer-focused rather than product-focused, and we tailor our solutions to customers' needs. This gives them confidence beyond the transaction. As a global insurance leader, Zurich offers great breadth and depth in our solutions for private equity firms and their portfolio companies.

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