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Q3 2018

PitchBook

R&W Insurance

PErspectives

on US Middle-Market Private Equity

Contents

Introduction

Deal and exit activity in the sub-$1B U.S. PE buyout market continues at a historically healthy pace

PErspectives on US Middle-Market Private Equity provides a quarterly analysis of deal activity, exit volume, valuation and fundraising trends in U.S. sub-$1B buyout funds. Our Q2 report included a detailed dive into first-time fundraising trends, and each report will spotlight different trends in this segment of the buyout market.

This quarter's edition compares and contrasts activity in the sub-$1B U.S. buyout fund market with the U.S. buyout market as a whole. While investment activity in H1 2018 in the sub-$1B buyout fund market declined marginally on an absolute basis, its decline was much milder than that experienced by the broader market. Investment activity in this sector of the market followed suit, declining marginally on an absolute basis and much less significantly than was experienced by the broader market. Despite these marginal declines, deal and exit activity continued at a historically healthy pace.

The most extreme divergence between this sector of the market and the broader market was the steep decline in fundraising. Fundraising in this sector of the market, both in absolute terms and relative to the broader market, has declined to levels not seen since the financial crisis.

Also included in this report is an interview with Craig Warnke, a managing director in Marsh's Transactional Risk practice, and Akerman's David Birke, co-chair of the firm's M&A and Private Equity practice. Mr. Warnke discusses the surge in interest in and utilization of representations & warranties insurance over the past few years, factors in deciding which of the burgeoning number of insurers to select, and the increased breadth of coverage available.

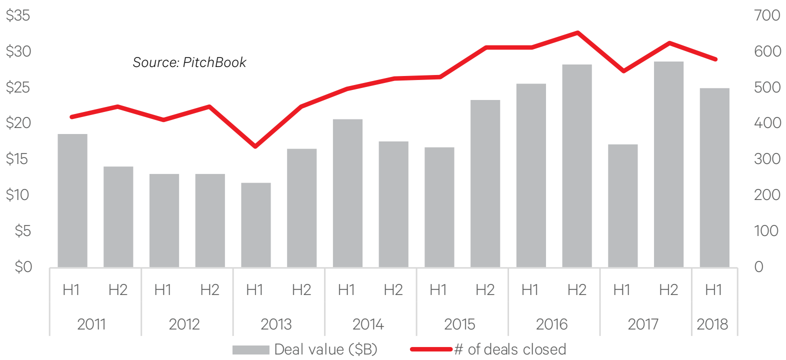
Also discussed are other considerations of which prospective investors should be aware before purchasing these increasingly important policies for their transactions.

Deals

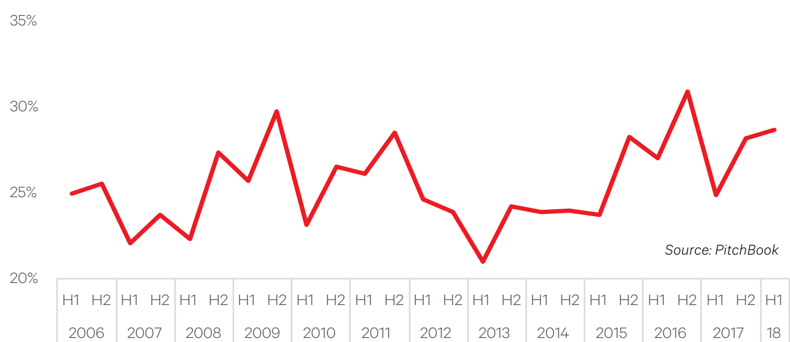
While deal activity for H1 2018 was at a historically robust level for sub-$1B buyout funds and exceeded activity for H1 2017, it declined marginally from recent historical highs. This sector of the market recorded 579 transactions worth $24.9 billion during 1H 2018, which was the fourth highest level ever, and the three higher levels all occured in 2016 or later. Dating back to 2009, every year has seen more activity in the back-half of the year by volume. Transaction value and volume for the broader U.S. buyout market for H1 2018, while at historically elevated levels, has declined marginally to the lowest levels seen since H1 2014 and H1 2013, respectfully. Volume has been broadly steady going back to 2014, averaging around 2,100-2,200 deals semi-annually in the timespan. Combined value also has been steady, occasionally eclipsing the $300 billion mark but averaging closer to $275 billion semi-annually. The overall market may have peaked in activity, while the sub-$1B PE buyout fund market continues to show routine strength. To visualize this, we directly compared the level of activity in the sub-$1B fund market to the overall buyout market. Starting in H2 2015, activity at the sub-$1B fund level became noticeably higher as a percentage of all U.S. buyout activity. The sub-$1B fund market typically accounted for 25% or less of total PE activity, but beginning in late 2015, that percentage began to settle into 27% to 31%. We expect that ratio to stay elevated heading into H2 2018, following strengthening trendlines across the U.S. middle market.

While purchase price multiples for U.S. sub-$1B buyout funds set an all-time EV/EBITDA record of 8.9x, there remains room for multiple expansions as multiples for the overall market also set records at higher levels. Multiples in this end of the market have been consistently lower than the overall market, which has seen medians of at least 10x going back several years.

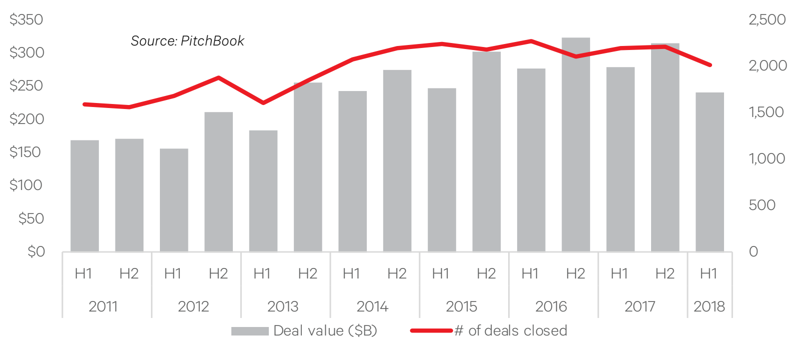
PE sub-$1B market deal flow (Akerman methodology)



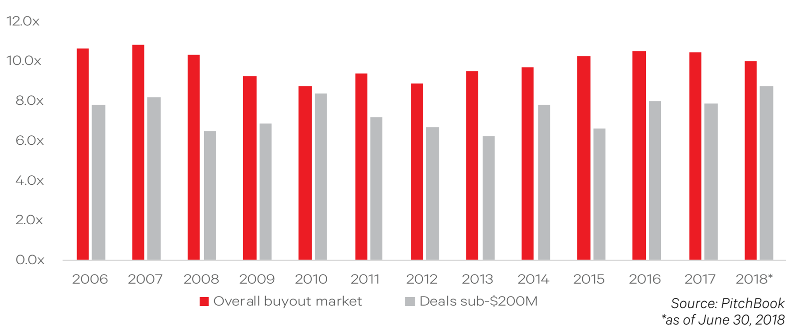
PE sub-$1B market as % of overall PE activity



PE overall deal activity



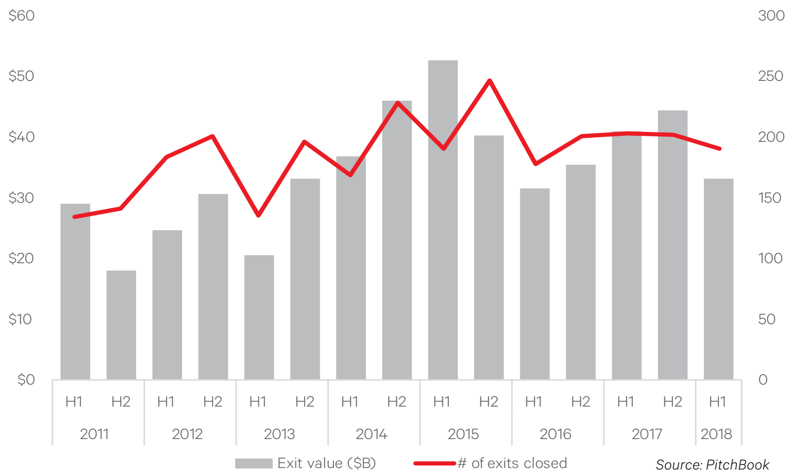
U.S. M&A multiples by year



Exits

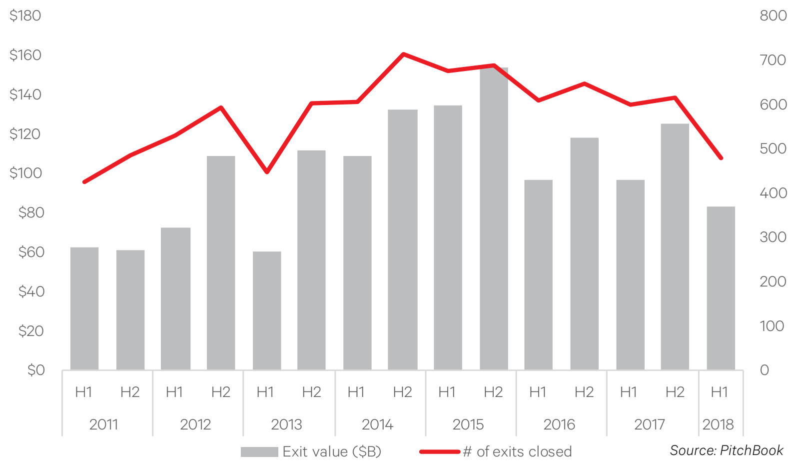
While exit activity is experiencing tailwinds from heightened investment activity during the past three to seven years (the typical hold period for buyouts), longer hold periods are creating headwinds. Although exit activity for U.S. sub-$1B buyout funds is still at a historically elevated level (albeit below recent record levels), its recent modest decline pales in comparison to the decline for the broader market. As such, the proportion of exits in this segment of the market has risen by more than 50% since the financial crisis to over 40% of the overall market. With PE dry powder levels continuing to reach new heights, it is reasonable to expect positive momentum in secondary buyouts (SBOs) and "up-sells" (smaller PE funds selling to larger PE funds), assuming that economic growth and financial markets remain healthy. Likewise, record amounts of cash on the balance sheets of strategic acquirers augers well for exit activity.

Sub-$1B PE exit activity (Akerman methodology)



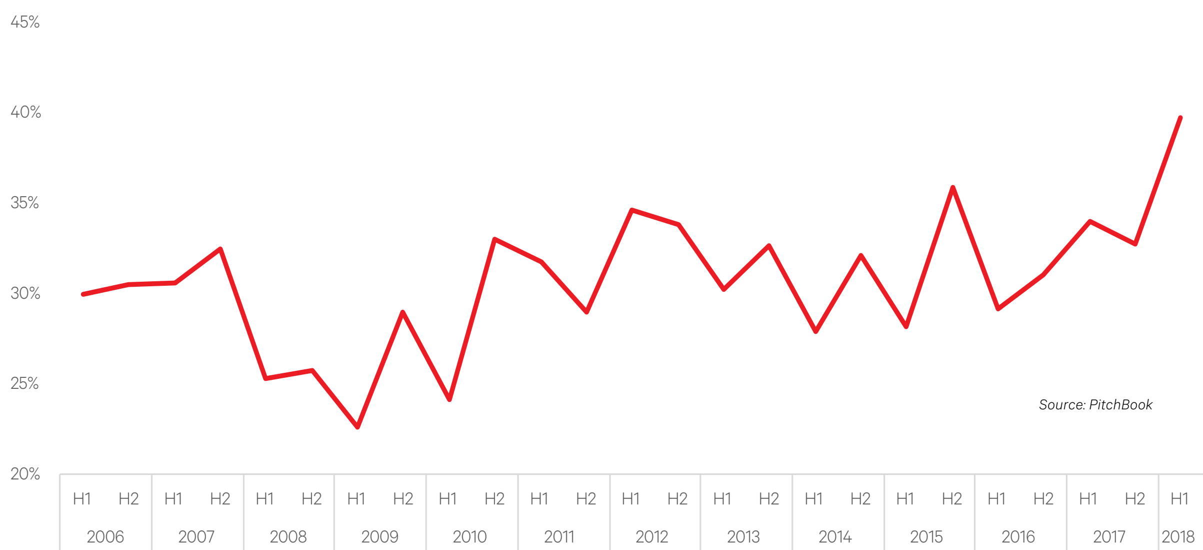
Source: PitchBook

Sub-$1B PE exit activity (overall)



Source: PitchBook

Sub-$1B PE exits as % of overall PE exits

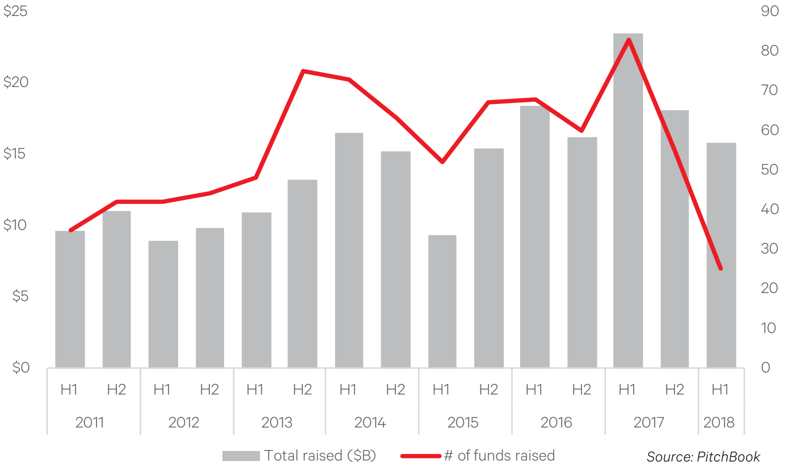


Source: PitchBook

Fundraising

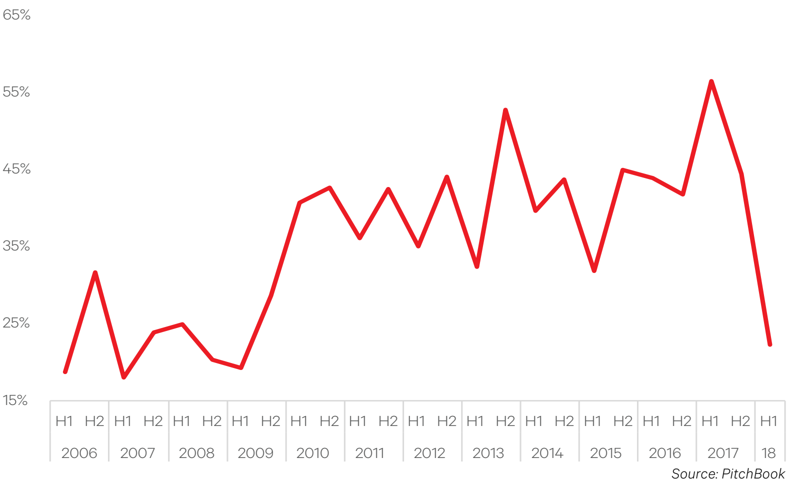
While the amount raised during H1 2018 by U.S. sub-$1B funds declined somewhat (and from a record in H1 2017), the number of such funds raised plummeted precipitously (to the lowest number since the financial crisis). Fundraising for the broader market diminished only marginally, leading the number of funds raised during H1 2018 at this smaller end of the market to account for less than 25% of funds raised in the overall market—a proportion not seen since the financial crisis. As was the case with the broader market, the fall-off in the number of funds raised was more dramatic than the fall-off in the aggregate dollars raised, reflecting a trend towards larger funds. Whether the relative under-performance for fundraising in this sector will continue will be of keen interest to GPs. What the statistics do not reflect is the massive strategy shift among LPs to invest in more sector- or geography-specific PE funds. Smaller, niche strategies—large enough for an expansive set of targets but nimble enough to invest effectively—have become a priority for LPs searching for diversification. Nonetheless, the demand from LPs to put increasingly larger amounts of capital to work efficiently, creates relative headwinds in fundraising for smaller funds. Looking forward, the tug-of-war will continue between concerns of investors about high valuations, economic cyclicality and a reversion to the mean for inflation and the historical risk-adjusted outperformance of this asset class.

Sub-$1B PE fundraising (Akerman methodology)



Source: PitchBook

Sub-$1B PE fundraising as % of overall PE fundraising



Source: PitchBook

Methodology

PitchBook: PitchBook defines the middle market as U.S.-based companies acquired through buyout transactions between $25 million and $1 billion. Note that minority deals are not included. This methodology covers only U.S.-based middle market companies that have undergone a buyout. PitchBook defines middle market funds as PE investment vehicles with between $100 million and $5 billion in capital commitments. The methodology includes only PE funds that have held their final close. Funds-of-funds and LP secondary funds are not included.

Akerman: Akerman's analysis of the sub-$1 billion market is performed at the investor level, defined by the investor's assets under management (AUM) and most recent fund size. All investors included in Akerman's methodology must have estimated AUM of less than $2 billion in total, with their most recent fund being less than $1 billion as well. Deals must be less than $200 million in size to be included in this methodology. Fundraising figures, however, include all funds of said investors. Exits must have said investor tagged as a seller/exiter on the given transaction. Geographic scope is also U.S.

Spotlight on R&W Insurance

With David Birke, Co-Chair of Akerman's M&A and Private Equity Practice, and Craig Warnke, Managing Director in Marsh's Transactional Risk Practice

Craig P. Warnke, Managing Director, Marsh

Craig Warnke is a managing director in the Transactional Risk Practice at Marsh. He advises clients on representations & warranties insurance, tax insurance, and other insurance products addressing contingent liabilities encountered on M&A deals. He has previously worked as an underwriter in AIG's M&A Insurance Group and as a corporate attorney at Willkie Farr & Gallagher.

David F. Birke, Co-Chair, M&A and Private Equity Practice, Akerman

David Birke is co-chair of Akerman's M&A and Private Equity Practice Group, where he represents private equity funds, family offices and their portfolio companies in complex acquisitions, divestitures, recapitalizations, restructurings, growth capital investments, and debt and equity financings.

David Birke (Akerman): Less than 10 years ago, some buyers offered representation & warranty policies to try to gain a competitive advantage in an auction process—or sellers might purchase a sell-side policy. Now it seems as though every seller expects the buyer to purchase a buy-side R&W policy. What percentage of middle-market deals use a buy-side R&W policy as the primary source of indemnity?

Craig Warnke (Marsh): While it's difficult to put a precise percentage on the deals using R&W insurance, we can affirmatively state that it is simply market standard for middle-market M&A deals to feature a buyer-side R&W policy. The increase in usage of the product over the past two to three years in North America is tremendous and shows no signs of abating. For example, see the chart below that shows the number of transactions using R&W insurance via Marsh in North America. Given our market share and the continuation of current trends, we would estimate that in 2018, well over 1,200 middle-market M&A transactions will utilize R&W insurance.

David: Early on, there were only a handful of insurers writing R&W policies. How much has the insurer base expanded and are the newcomers traditional underwriters or alternative providers?

Craig: The expansion of the underwriter base in the R&W insurance marketplace has been nothing short of remarkable. Just a few years ago, we could find that our clients had only one (or even no) option for a difficult to place risk, given the limited number of players in the market. That same risk today would likely attract multiple and attractive quotes from insurers. In 2018, there are approximately 20 credible underwriters capable of providing primary R&W insurance terms on middle-market M&A transactions, with many others willing to participate on excess layers. Given the sheer number of market participants, there is well over $1 billion of R&W insurance capacity that can be deployed on a single transaction should the need arise, which was recently validated on a transaction where Marsh placed aggregate policy limits in excess of $1 billion on a recent transaction.

The expansion of underwriting capacity has come from both traditional insurance companies as well as from managing general underwriters (MGU). For insurance companies, the R&W sector represents an attractive source of premium growth that covers risks generally uncorrelated with their overall book of business. This also made it relatively easy for experienced and entrepreneurial underwriters to start their own MGU and find insurance company partners.

David: Are buyers choosing insurers strictly based on price and exclusions or are other factors significant to the decision?

Craig: Pricing is certainly a significant factor for our clients when it comes to choosing an underwriter. In light of the prior discussion, the increase in the number of R&W insurance underwriters has led to dramatically increased competition in this sector, resulting in lower premiums across the board. We estimate that premiums for primary R&W insurance are approximately 10% lower than 2017 premiums (and this follows on the heels of a 9% pricing decrease in 2017 from 2016).

While clients are enjoying the benefits of lower pricing, our advice to them is that pricing is just one facet to consider and should not be the determining factor in selecting an insurer. We believe that the "right" insurer for a particular transaction is a function of the coverage being provided (with an emphasis on any deal-specific exclusions), ability to execute, claims-paying history, relationship(s) with the client or counsel, along with the premium.

David: Have you seen insurers getting more comfortable with risks that they seem to have previously been excluding (e.g. government reimbursement and FLSA matters)?

Craig: In short, yes. Underwriters have expanded their underwriting appetite in response to the competitive landscape plus a favorable loss history across the industry. Issues that may have been categorically excluded a few years ago, including government payor reimbursement risk and FLSA matters (just to name two examples), are now eligible to be covered under an R&W policy subject, of course, to satisfactory underwriting results. Though insurers have liberalized their underwriting appetite, they have not relaxed their underwriting standards as coverage is still predicated on the buyer having done robust and comprehensive due diligence.

David: What trends are you seeing in claims being asserted under R&W policies and how are the insurers responding? How long does it typically take for claims to be paid?

Craig: We are simply seeing more claims being made under these policies—but this is purely a function of more policies being written. We have not observed a meaningful increase in the percentage of our policies that have claims, which remains in the range of 10%-15%, depending on policy year. The biggest driver of claims across our portfolio is breaches in the financial statements representations—with taxes, employee benefits and compliance with laws claims not far behind.

Insurers have taken the increase in claims in stride and have taken (in our estimation) a very reasoned approach in claims settlements and negotiations. In just the past year, we've secured payments in the tens of millions of dollars for our clients under these policies.

As to the timing of claims payments, it's very fact-specific and depends on the nature of the underlying claim and whether it's tied to underlying litigation, etc. I've had claims settle in as quickly as 60-90 days while others have gone on for a number of years.

David: What are some of the more material issues of which a buyer needs to be aware in selecting a policy?

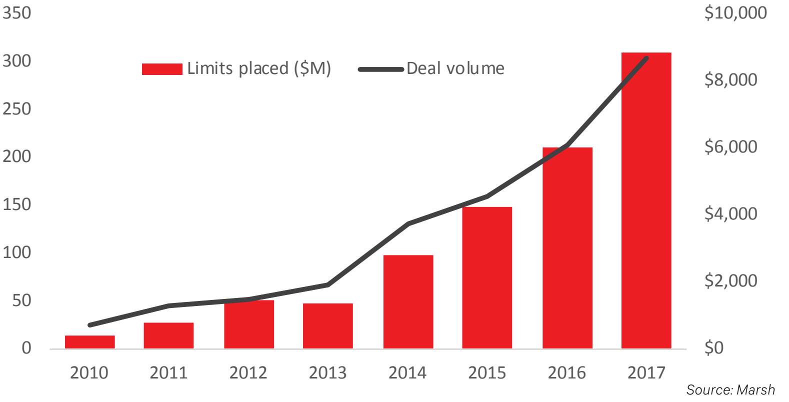
Craig: When utilizing R&W insurance on a transaction, buyers need to be thoughtful about their due diligence process, ensuring that they don't view the procurement of the policy as a substitute for due diligence. As stated earlier, the insurers are expecting buyers to do thorough and robust due diligence on every transaction. That said, insurers do recognize that a "one size fits all" approach doesn't work in today's marketplace, and they are willing to accommodate each buyer's approach—as long as the work gets done.

Buyers should also focus on working with seasoned advisors in the R&W insurance process, as executing on aggressive deal timelines is critical to the success of the transaction.

David: How does Marsh distinguish itself from other brokers in the R&W insurance lines?

Craig: At Marsh, we pride ourselves on our deft management of all aspects of the brokerage process. We staff all of our transactions only with senior-level and experienced R&W insurance brokers (as opposed to more junior analysts), capable of executing on all manner of M&A transactions under aggressive timelines. We believe that our team of 10 senior brokers in North America with another 25+ brokers in Europe, Asia and Australia offer unmatched experience and provide our clients with best-in-class service on their R&W needs across the globe.

Representations & warranties insurance volume by year



Source: Marsh