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Mergers and Acquisitions

Private Equity Firms and Portfolio Companies: Why Hiring a Risk Management Consultant Makes Sense

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Many private equity firms and their portfolio companies are not in a position to hire a full-time risk manager. However, they can hire independent risk management consultants for the advice they need and to help them achieve their risk management goals. Risk management consultants also can help to counter the "silo effect" that occurs when the insurance industry underwrites within industry-specific guidelines only. This doesn't allow for any creative solutions and yields repetitive transfer structures with the same results year after year.

The numbers tell the story. As an example, one of CohnReznick's private equity firm clients hired an independent risk management consultant to conduct due diligence on prospective acquisitions for its 18 portfolio companies. The relationship saved the private equity firm more than $40 million in insurance premiums and increased the portfolio company valuations by more than $100 million.

An Independent Perspective

Independent risk management consultants often start with a full audit of a portfolio company's exposure to risk through a review of its existing insurance contracts. They often find that the insurance companies are offering relatively generic policies and can recommend changes to the company's coverage to better target the company's specific needs. Many companies also find themselves over-exposed and/or under-covered. They may be buying insurance for risks that they won't realistically face, and components of their current insurance program may not align with their particular risk profile. The consequence of this is payment of excess premiums that could total millions of dollars, reduce the portfolio company's earnings, and lower the private equity fund's total return. Gaps in coverage could be even more disastrous.

Independent risk management consulting firms bring a unique perspective to the analysis, negotiation, purchasing, and performance oversight of insurance products and services. Operating from a vantage point that is outside of the insurance sales and distribution system, these consultants can strengthen a financial officer's ability to obtain optimal transfer-of-risk products and services at the most competitive terms. The risk management consultant will also identify coverage gaps, recommend enhancements, negotiate rates and, most importantly, help the insurance "system" work to the company's advantage.

Reading the Policy

Most executives from private equity firms and portfolio companies simply don't have the time to read their insurance policies. A typical insurance policy can run to 100 - 200 pages of highly technical contractual language. Risk management consultants are hired to carefully read through the insurance policies purchased by their clients – often starting with the exclusions and endorsements in the back. Each policy begins with a summary of the insurance coverage followed by page after page of definitions, conditions, exclusions and endorsements that can often substantially alter, reduce, or even eliminate coverage that the buyer thought was purchased.

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Negotiating the Coverage

Risk management consultants guide their clients through the process of negotiating with their existing brokers and insurance providers, or soliciting and evaluating bids from alternate providers. When the written insurance policy arrives from the insurance company, they carefully review and verify the policy, with all of its exclusions and endorsements, for their clients. They will also carefully examine the levels of exposure that their clients choose to retain through the purchase of high-deductible or high-retention insurance policies. Typically, the formal administration of these self-insured or retained claims is carried out by an insurance company or a Third Party Administrator (TPA). Risk management consultants carefully track the cost of claims and help to ensure that the claims administrator has the resources to handle these self-insurance claims from both a staff experience and overall workload perspective.

The Due Diligence Review

The value of engaging an independent risk management consultant is especially significant for the due diligence process, when every dollar saved in operating cost can add multiple dollars to the valuation of the company. If private equity firms and their portfolio companies do not carefully understand their exposures, and how to request/negotiate for their insurance, they can miss out on discounts, credits, or coverage that insurance companies offer to companies with a similar risk profile. Some portfolio companies with more than $700,000 a year in insurance costs (other than health and pension insurance) have often achieved annual savings from four to more than twelve times the amount of the annual fee they pay for the service.

Finally, when a private equity firm is evaluating a potential acquisition, the risk management consultant conducts a due diligence process that analyzes the risk management issues involved and recommends both insurance and non-insurance-related actions where necessary. In many cases, the consultants find significant potential insurance savings that can make a financial impact in getting a deal done.

If you believe your firm can benefit from the services of a risk management consultant, CohnReznick can help by referring you to one of the independent consultants we work with. To learn more, please visit www.cohnreznick.com.

Submitted by CohnReznick

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Mergers and Acquisitions Are Strong in a Slow Growth Economy

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Five years after the collapse of Lehman Brothers, marking the beginning of the credit crisis of 2008 and great recession, the global market for mergers and acquisitions is remarkably healthy. So far this year, total announced global deal flow is $1.65 trillion. This is slightly ahead of the deal value of $1.56 trillion for the same period last year, according to Bloomberg.[1] Of course, "slightly ahead" may not be the most descriptive phrase when you are talking trillions. The difference between 2012 and 2013 is $90 billion!

About half those deals occurred in North America, almost a third were in Europe, and one-fifth were in Asia. We have seen some very large and exciting deals, including Verizon Communications' $130 billion buyout of their joint venture partners stake in the U.S. wireless business, the $40 billion acquisition of Sprint by Japanese tech giant Softbank, and the $27.4 billion buyout of American icon H.J. Heinz by Brazil's 3G Capital and Berkshire Hathaway.

The healthy market is surprising when you consider we narrowly averted a second major debt crisis in Europe last year, that Europe is barely out of recession territory, and that the global recovery is characterized by steady but unimpressive economic growth.

What are the key drivers of the healthy M&A activity in a slow-growth economy?

Strong balance sheets and low interest rates

Many companies, after boosting productivity and getting lean and mean to get through the last recession, have strong balance sheets. Central banks around the world have kept interest rates low with accommodative monetary policy. Private Equity firms have successfully raised capital coming out of the recession and are very active. Private Equity, strong corporate balance sheets, and access to low-cost financing are a winning formula to drive M&A activity forward in a slow economy.

Consolidation

Beyond the macroeconomic conditions, we have several powerful industry trends at play. The first is consolidation, especially in the technology sector. A boom in technological innovation and a renewed interest in the internet space over the last few years have created many startups in software, social networking, online payments, and mobile apps. Small and established firms alike are acquiring competitors to scale up, gain clients and acquire talent. Yahoo has led this charge by purchasing 18 companies in social media and web technologies, including the popular blog Tumblr for $1.2 billion, since new CEO Marissa Myer took the helm 18 months ago. Google, Apple, Microsoft, Oracle, Cisco, and many other tech firms are also very acquisitive. San Diego security software maker Websense caught this wave and was taken private by Austin based Vista Equity Partners in June.[2]

Verizon wrote a chapter in the textbook for industry consolidation by buying out Vodafone, its European partner in its U.S. wireless business. This merger had both financial and strategic advantages for Verizon, as the merger allows it to capture substantial additional cash flow from the business and exercise full management control in the future.

Thermo Fisher Scientific's $15.9 billion buyout of Carlsbad based Life Technologies announced in April is the 11th largest merger worldwide, and was another consolidation play in the research and diagnostics market.[1]

Cross Border

As globalization continues, companies are stepping up their M&A activities in other countries to gain scale and access to customers and suppliers worldwide. Just the other day, computer chip equipment giant Applied Materials announced the buyout of Japanese rival Tokyo Electron for $9.4 billion.[3] Cross-border expansion and consolidation are the dual drivers as the combined company will have a larger global footprint in a slowing industry that serves computer makers around the world and requires continued capital investment. This is the largest cross-border acquisition of a Japanese firm since 2007, and the first all-stock transaction for a Japanese company. Also, shareholders of Smithfield Foods recently approved the buyout by China's Shuanghui International, the country's largest pork producer. This is the largest buyout of a U.S. firm by a Chinese company to date. The Smithfield deal is a win-win for both companies, as Smithfield will acquire greater access to the Chinese market and Shuanghui will acquire U.S. food safety technology. As U.S. companies move abroad, foreign buyers move to the U.S. The H.J. Heinz deal is the third major U.S. acquisition by Brazil's 3G Capital, following the prior deals for Burger King and Anheuser Bush.

Intellectual Property

With epic worldwide patent wars raging between Apple, Samsung, Google, Microsoft and many others, buying companies for their trademarks, brands and patents is a popular strategy. Patent portfolios can sometimes be the most valuable asset of a firm. Patent acquisition was the main driver behind Google's $12.5 billion acquisition of Motorola Mobility last year, in which Google acquired about 17,000 patents that now may be used to defend the Android operating system. The patent portfolio is one of the most valuable assets of smartphone maker Blackberry, which itself is the subject of a recently announced $4.7 billion takeover offer from its largest shareholder, Fairfax Financial. Until there is a cease fire in the patent war, we will continue to see M&A activity driven by the pursuit of intellectual property around the world.

Regulation

While it is conventional wisdom that regulation is a drag on economic growth, surprisingly it can also encourage M&A activity. In the U.S., increased regulation is fueling a merger boom in the banking industry. As small banks pass the threshold of $10 billion in assets, and then again at the next breakpoint of $50 billion, they become subject to a number of new and expensive regulatory requirements under the Dodd-Frank law. This incentivizes banks near or just over the thresholds to bulk up and increase scale to deal with the regulatory burden.

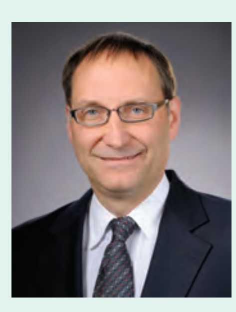
M&A and the public markets

There is a virtuous cycle between M&A and the public stock and bond markets. Mergers benefit from healthy public market conditions and fuel them. Mergers, especially large ones, create excitement and investors interpret them as a vote of confidence in the future of the market and the economy. Mergers are a perennial source of fees for Wall Street investment banks, attorneys, and valuation firms. Mergers create wealth and liquidity for the sellers. M&A activity also supports the bond market. Verizon sold $49 billion in the largest bond offering in history two weeks ago to finance its Verizon Wireless buyout.[4]

Our bottom line? We expect the global economic recovery to stay on track and with it, the positive environment for mergers and acquisitions.

Sources:

1. Bloomberg "MA" page (updated daily).
2. San Diego Business Journal, June 27, 2013
3. Bloomberg News, "Applied Materials to buy Tokyo Electron in 9.39 Billion Deal", Sept. 24, 2013
4. LA Times, "Verizon raises $49 billion in biggest bond sale in history" Sept 11, 2013, http://www.latimes.com/business/la-fi-verizon-bond-sale-vodaphone-20130911,0,6338712.story



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