PEI Alternative Insight

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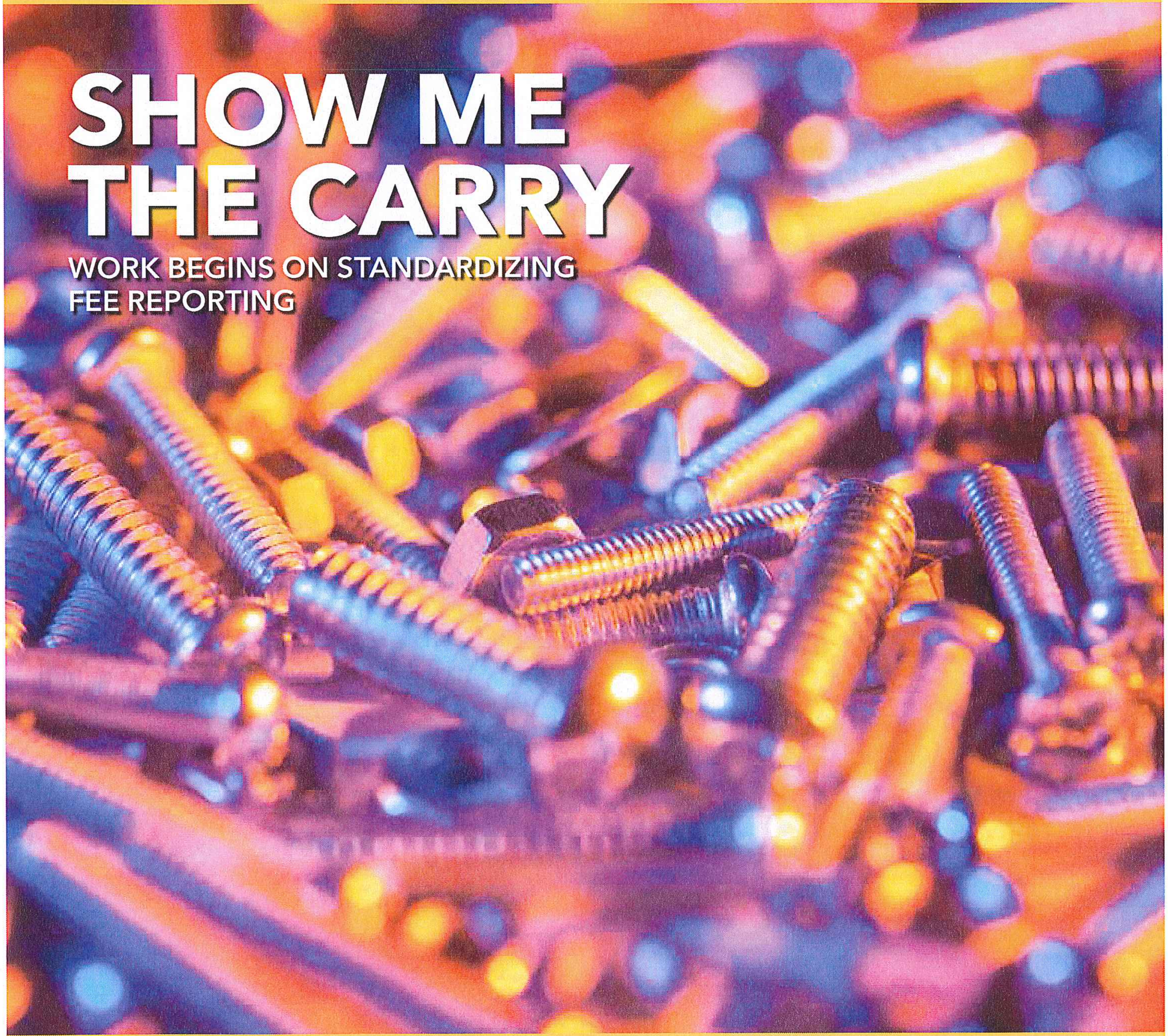
WORK BEGINS ON STANDARDIZING FEE REPORTING



CYBERSECURITY INSURANCE
Are the policies worth the cost in PE?

KNOWN UNKNOWNS
A special report on risk management

HELLO CUBA
Is the island state ready for PE?

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editor's letter

Risky behavior

Risk is always a fun topic to explore when we put together our August issue, in part because we can take the topic in so many different directions.

Really the process starts with asking CFOs, COOs, lawyers and accountants a pretty simple question: what's the single biggest risk facing your profession in the next 12 months? We get all sorts of interesting answers that help shape our coverage, but this time around we noticed one common denominator in the responses we received: cybersecurity.

I can't say that I'm surprised, given the amount of attention given to cybersecurity by lawmakers, regulators and investors in the last two years. In the past we've covered what types of IT best practices private fund managers are pursuing now that cybersecurity has become so entrenched as a hot-button issue – but for this, our annual risk special, we took things in a slightly different direction by asking about cybersecurity insurance.

From what we gathered, many private fund CFOs and COOs are in the process of shopping for cybersecurity insurance policies, but some are finding the coverage on offer not worth the cost. Nonetheless, CFOs are attuned to the fact that purchasing cybersecurity insurance is likely to win points with LPs and regulators. See p. 20 for all the details.

Speaking of insurance, over the last year there has been a huge surge of interest in reps and warranties insurance in the M&A markets. The problem, however, is that these policies take time and skill to acquire, with lingering questions as to how much insurers will pay on a claim. It's an area of risk GPs are still feeling out. See p. 24 for more.

Elsewhere in the issue, we tackle investor reporting, specifically carried interest, which has become a major point of contention ever since CalPERS, the bellwether LP, took media heat for not knowing how many dollars in carry its GPs receive. It's a complex area filled with mixed opinions. On p. 35, we walk you through the issue, and ask what it all means for fee reporting in the time ahead. Allow me now to predict that carried interest reporting is an administrative challenge more CFOs will mention when I ask them about their biggest fears or risk areas in 2016.

Enjoy the issue,

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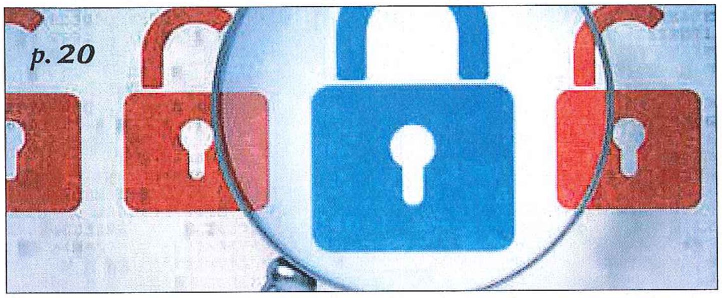
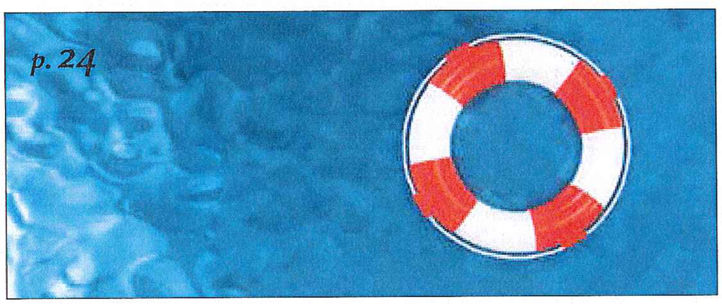
special report: risk



Cybersecurity insurance: maybe not worth the cost



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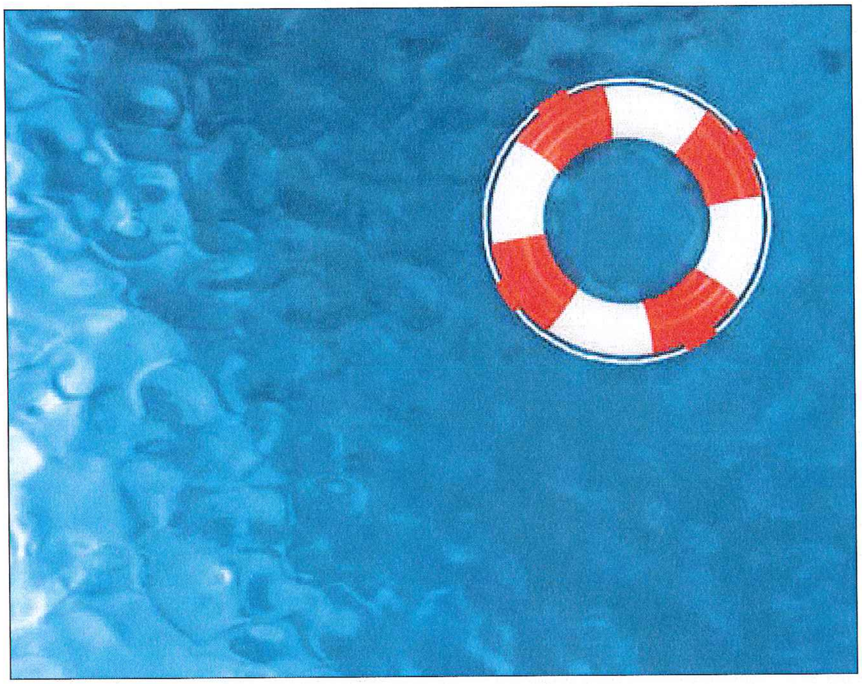

Reps and warranties insurance: how much are you really saving?

An unproven lifesaver

Reps and warranties insurance may be more popular than ever, but these policies take time and skill to acquire, with lingering questions as to how much will be paid on any claim

by ROB KOTECKI

According to a recent joint report from the law firm Dechert and the insurer Marsh, the number of reps and warranty policies has quadrupled from 2012 to 2014, with an additional 20 to 30 percent growth this year. The popularity of such policies is easy to understand. Representation and warranties insurance (RWI) can be acquired by either the buyer or seller in an M&A transaction and acts to replace some, if not most, of a seller's indemnification obligations in the event of a breach of any reps or warranties.

For example, a seller might have to put 10 percent of the deal's value in escrow to cover breaches in reps and warranties, but with such a policy in place, they may need only 1 percent as a "retention amount." No policy covers the first dollars of loss. Naturally, sellers might find the premium worth paying, but these days, nearly 80 percent of policies are on the buy-side, with many bidders purchasing these policies to sweeten their offers, and many sellers requiring RWI as part of any bid.

But the big question is whether the carriers will pay out any major claims. Several market participants cite that so far, 20 percent of such policies have seen claims filed, but often below the retention amounts, so the insurers haven't been forced to make any major payments yet. Skeptics of RWI suggest that after a few credible claims are rejected, this boom might go bust. But the boom might prove to be the rationale for the claims to be paid out in the end.

Given the popularity of RWI policies, some experts suggest it would make more sense for insurers to pay on credible claims for no other reason than to protect such a substantial line of business. Whether carriers act in such enlightened self-interest remains to be seen, but in the near term, buyers might have little recourse but to rely on the kindness of the insurance companies, since sellers have little desire to back up their reps and warranties by escrow alone.

Give yourself time

The other major factor involved in assessing the value of RWI is the amount of time and effort it requires to purchase a policy.

Buyers should check with brokers early to make sure it's available for that particular transaction. Insurers review all the diligence materials before offering a "bindable" quote for the policy. RWI policies can be hard to get for certain situations and there's a chance that due to surging demand, applications can take longer to process, and be less competitively priced. The larger issue is how much any such policies will pay out, with some skeptics thinking that RWI has yet to prove itself worthy of its current popularity.

Experts suggest that RWI is important in distressed deals, where buyers aren't certain they could be compensated for any breaches in bankruptcy court. In cross border transactions, RWI can protect a buyer concerned that foreign jurisdictions wouldn't rule in their favor in case of a breach. "We've had some situations

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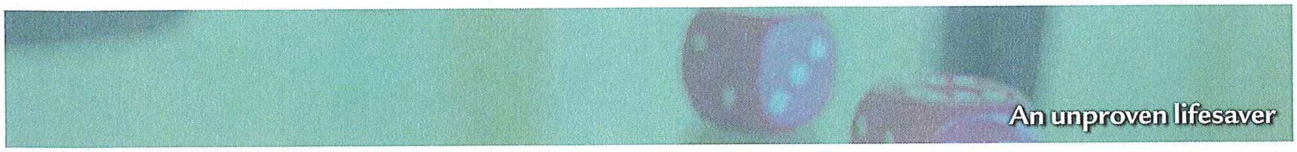

where there are doubts about either local courts enforcing contractual obligations or US courts respecting foreign judgments," says George Wang of the law firm Haynes & Boone. However, the real surge in RWI policies can be linked to a seller's market, where competitive auctions tilt the advantage away from the buy-side of the table.

But RWI doesn't make sense for every deal, no matter how willing a buyer may be. Most policy coverage limits vary between $10 million and $350 million worth of coverage, falling well in the range of middle market deals. In most cases, premiums will amount to 3.2 percent to 4 percent of the coverage limit, though there are cases where it's been available for as low as 2 percent. Policies are available with limits under $10 million, but are increasingly expensive and difficult to obtain. However, that may be changing. "In just the last few months we're seeing some carriers offer minimum premiums as low as $50,000," says Alex Jezerski, Jr. of the wholesale insurance broker RT ProExec.

If an RWI policy makes sense, GPs should start shopping early. Brokers don't see a lot of success with eleventh hour searches for a policy. It can take several weeks in the best of circumstances, and while insurers are willing to speed up the process, there's no guarantee they can.

700

Number of R&W policies issued in 2014 (double the amount of policies issued in 2013), according to Dechert and Marsh research

30%

Upper-bound growth estimate of R&W insurance by end of 2015

The process begins with an indication period, where the buyer shares deal documents, financials and the core facts of the transaction with a broker, who then hunts for potential policies. That hunt usually takes two weeks. The broker will then return with options for coverage.

Once the buyer selects a potential policy, that insurer will then tap their own counsel, and will do their own diligence on the transaction, reviewing the documents in the digital data room and examine the quality of the buyer's initial diligence. "It's my sense that in issuing coverage, insurers can gain comfort by knowing who is participating in a deal and the quality of the due diligence done in connection with the deal," says Mark Hersh of the law firm Reed Smith.

"If an RWI policy makes sense, buyers should start shopping early. Brokers don't see a lot of success with eleventh hour searches for a policy"

As RWI has evolved, so has the talent involved in these diligence efforts. "Ten years ago, you'd be talking with an insurance guy, but nowadays, you'll be talking with a former M&A deal lawyer who really understands the nature and language of these deal agreements," says Wang. And that can mean a tougher diligence review process, but a policy that might better serve the terms of the agreement.

One firm's in-house counsel pointed out that private equity firms should look at any non-disclosure agreements (NDAs) and revise them to include insurers among the parties covered by an NDA. They noted it might be a stretch to consider these insurance diligence teams as advisors, traditionally covered by NDAs.

The insurers diligence period can take a week or longer, ending with a conference call between the deal team and the insurer's diligence staff where they'll discuss any questions or concerns they may have. Then the policy buyer will have a "bindable" quote to take to the negotiating table. At best, the entire process could take three weeks in total, maybe less, but in today's market, buyers shouldn't expect a swift turnaround.

A number of market participants said that as RWI policies have surged in popularity, there remain only about a dozen or so insurers who offer them. That means staffs are overwhelmed with deal flow, and that can lead to delays. At times, brokers go looking for five or six bids for a transaction, but can only find two, and sometimes, none at all.

"Your broker has to really understand the deal in question and know how to talk about it with the carriers," says Jezerski. "With staffs so overworked, they'll appreciate a deal that's explained in clear and concise terms." Easier said than done. ■