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Proactive insurance risk management at private equity portfolio companies adds value to the bottom line

More and more private equity sponsors are increasing stakeholder value by improving the operating efficiencies of their portfolios. In the current market where deal activity is challenging and the initial public offering market is on hold, effective insurance risk management (IRM) at portfolio companies is one of the ways for private equity sponsors and management to drive value. Because of resource constraints, private equity sponsors concentrate on top priority initiatives, abandoning many other worthwhile savings programs, including IRM opportunities that could lead to potential cash savings in the millions. However, with an outside adviser these opportunities can be captured by private equity sponsors.

Private equity sponsors who have a common portfolio insurance risk management program have much to gain. Especially, when they are involved in a carve-out transaction in which the spun-off business lacks internal infrastructure and support services are provided by the target's parent. The property insurer of the target's parent may be unwilling to insure a carve-out business after the closing on a stand-alone basis because its property risks might be too high. In this situation, the newly acquired portfolio can automatically enter the private equity sponsor's property insurance portfolio program which can be designed to readily accept new acquisitions.

Often, sustainable cost savings can be achieved by making simple improvements to the risk management and safety practices at portfolio companies. By leveraging the purchasing power and aligning insurance risk management strategies of portfolio companies, private equity sponsors can decrease insurance premiums and vendor costs while improving services and coverage terms. Typically, implementing a leveraged purchasing arrangement decreases premiums, vendor fees and loss costs by 5 to 20 percent—a significant cash saving.

HIDDEN CASH IN AN EFFECTIVE PORTFOLIO INSURANCE RISK MANAGEMENT PROGRAM

Insurance risk management (IRM) is a hidden opportunity in which strategic portfolio company purchasing approaches can improve profits and cash flow. Insurance risk management deals with non-employee benefits risks such as directors' & officers' liability (D&O); worker's compensation; general and product liability; auto, property and fiduciary liability; and employment practice liability. IRM expense is made up of insurance premiums; retained claims such

as deductibles of self-insurance; vendor fees such as insurance brokers and claims service providers; internal administrative costs; and collateral costs such as letters-of-credit. Efficient management of IRM expense leads to annual insurance savings that increases cash flow.

Furthermore, an insurance program established across portfolio companies should provide pre-set run-off terms for D&O and portable casualty coverage, thereby minimizing uncertainty upon exit. A successful IRM program involves leveraged

purchasing, optimization of insurance programs, risk management practices and broker/insurer relationships.

Effective portfolio insurance risk management answers crucial cash opportunity questions such as:

- Are D&O and insurance policy terms appropriate and consistent throughout the portfolio?
 - Are we leveraging collective buying power across portfolios to obtain maximum cost benefits?
 - How can we pre-set "run-off" premiums?
 - Is there cash trapped in a captive insurance company? What is the cash minimum limit?
 - Can we create a flexible, portable portfolio insurance risk management program to include future portfolios and help with exit strategies?
 - Can we use a consistent portfolio program to address coverage gaps?
 - Are existing broker relationships competitive and independent?
 - Are we sharing insurance risk management best practices across portfolios to lower insurance and loss cost?
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Is your insurance program leveraged?

Leveraged purchasing is often in the eyes of the beholder. Some programs may be considered leveraged because they are executed on a portfolio-wide basis with common approaches to the insurance buy — in terms of coverage, limits and deductibles as well as centralized purchasing and shared insurance programs. Others may be considered leveraged because they use the same insurance broker.

Many savvy Fortune 500 risk managers use two or more insurance brokers. This commonly accepted best practice gives risk managers the ability to leverage the best brokerage resources, more varied insurer relationships and intellectual property in a highly competitive environment. While using one broker implies simplicity, a common broker alone may not lead to insurance buying leverage. This approach may expose private equity sponsors to additional risks such as broker expertise and the balance between pleasing the portfolio company versus sound insurance decisions.

Leverage is not achieved unless there is a common strategic approach across the portfolio to the same insurers and, optimally, shared insurance programs for certain coverage such as property and D&O. Two "leveraged purchasing" attributes are combining the buying power of portfolio companies to achieve best in class efficiency and introducing risk management best practices across the portfolio. These two characteristics could lead to significant annual savings for the portfolio company and the private equity sponsor.

Leveraged purchasing, coupled with a practical approach to share coverage across controlled companies, is a proven means to reduce premium costs, achieve coverage consistency and obtain optimal terms. It is important to note there are practical limits to the amount of premium cost reduction achieved from group purchasing. Leveraged purchasing alone is not a comprehensive approach to tackle portfolio risk costs. However, the combination of leveraged purchasing, optimization of insurance programs and vendor relationships offers private equity sponsors a comprehensive, holistic approach to managing insurance expense.

Are you optimized?

Optimization is a broader systemic approach to cost reduction, starting with claims retained under deductibles, which heavily influence collateral requirements and overall insurance premiums. Optimization is a transformational process which elevates portfolio company risk management practices to lower costs across the spectrum of risk management expenses. Its primary focus is reducing retained casualty claims costs and their indirect expenses such as claims management and legal fees.

Optimization is cost effective and offers many advantages such as:

- Premium, loss cost and vendor cost reduction
- Risk identification and control
- Improved coverage terms
- Actionable and measurable steps to optimizing insurance risk programs

Portfolio companies should not be presumed to have achieved optimal risk management results since results are a function of ability, resources and management support. Often private equity sponsors find the "capital" they need to achieve success is their support for the initiative. Obstacles are frequently related to changes in structure and broker relationships. Some portfolio companies are actively or passively resistant because of a perceived loss of autonomy. Such potential barriers are not unfamiliar to private equity sponsors, who regularly find meaningful improvements require behavioral changes at the portfolio company.

Are you receiving the best advice?

Leveraged purchasing programs are managed and executed by an insurance broker who is critical to the insurance procurement process. The broker's primary revenue is associated with insurance placement; therefore, the broker naturally concentrates on the insurance "buy" or purchasing insurance coverage on behalf of the private equity portfolio company. Although the procurement function is important, the "buy" may not be the greatest optimization vehicle, and procurement expertise should not be taken as a substitute for sound risk management advice.

Insurance brokering is highly competitive and brokers rightfully strive to maintain portfolio company business post exit. The broker's relationship (post portfolio company exit) is tied to satisfying the portfolio company consequently the broker is placed in a difficult situation if their advice is contrary to the portfolio company's view. As a result, it may be difficult to get the straightforward professional advice needed to achieve insurance leverage and optimization to reduce insurance risk and expense.

An independent adviser can offer independent insurance purchasing advice and provide the operational risk management experience to optimize insurance risk management across portfolios to break down corporate silos. Having an experienced adviser becomes critical when the private equity sponsor is engaged in a carve-out and lacks internal risk management resources. In a carve-out, the newly stand-alone company needs to develop and implement a cost efficiency program since a new program must be created. Unless the private equity

sponsors engage an independent adviser, they may not have the requisite hands-on risk management experience.

An experienced and independent adviser can make a profound difference. For example, shortly after completing an acquisition, the private equity sponsor learned its newly acquired company — because of its leveraged balance sheet — could lose its qualified self-insured status for worker's compensation (WC) in key US states. Prior to the closing of the deal, the surety underwriter who provided uncollateralized surety bond capacity securing the self-insured WC states was cutting back on capacity and requiring 100% collateral to support the surety bonds. The private equity sponsor was faced with an unexpected additional \$100 million in letters-of-credit requirement.

PricewaterhouseCoopers was engaged to assess and provide advice on how to resolve the issue. The recommended strategy developed with the portfolio company was to deal with the qualified self-insured issue on a state-by-state basis to minimize additional collateral, and a new surety broker was introduced who was able to replace the surety capacity.

In another example, at the request of a private equity client, PricewaterhouseCoopers recently conducted an independent review of the company's risk management function across portfolio companies and identified annual sustainable savings of \$25 million that could be achieved by improving risk management and safety best practices.

To ensure IRM programs at portfolio companies are competitive, private equity sponsors should review their broker relationships in the open market every three to five years.

IN CONCLUSION

Private equity sponsors need a proactive systematic insurance risk management strategy for their portfolio companies to reduce insurance risk management expense. Those who foster insurance risk management best practices across portfolio companies have the opportunity to:

- Reduce insurance loss expense by increasing commitment to pre- and post-loss management programs. Designing and managing risk management portfolio program to target loss cost reduction and serve as a platform for the portfolio companies to disseminate and maintain best practices
- Unify the portfolio companies and act cohesively thereby bringing to bear the purchasing power and cost management techniques of Fortune 500 companies to achieve:
 - Improved consistency of risk strategy and insurance coverage levels
 - Reduced frictional costs for service providers, such as insurance brokers,

management information systems, defense attorneys, medical providers, third party claims managers, loss control engineers and safety programs

- Reduced collateral, and
- Ease of and cost efficient entry and exit strategy

Sustainable cost savings can be achieved by the private equity firm and its portfolio companies by concentrating on these insurance risk management opportunities through leveraged purchasing and optimization of insurance programs in an open market.

TS Insights provides strategic thinking on a wide range of issues that affect the deal community. *TS Insights* is a publication of the Transaction Services Group of PricewaterhouseCoopers, which includes over 1,200 professionals in 16 US cities. For more information on the topics discussed in this issue, contact **John Merrigan** at (646) 471-5847.

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