Gallagher

Insurance | Risk Management | Consulting

Private Equity Risk Outlook Survey 2022

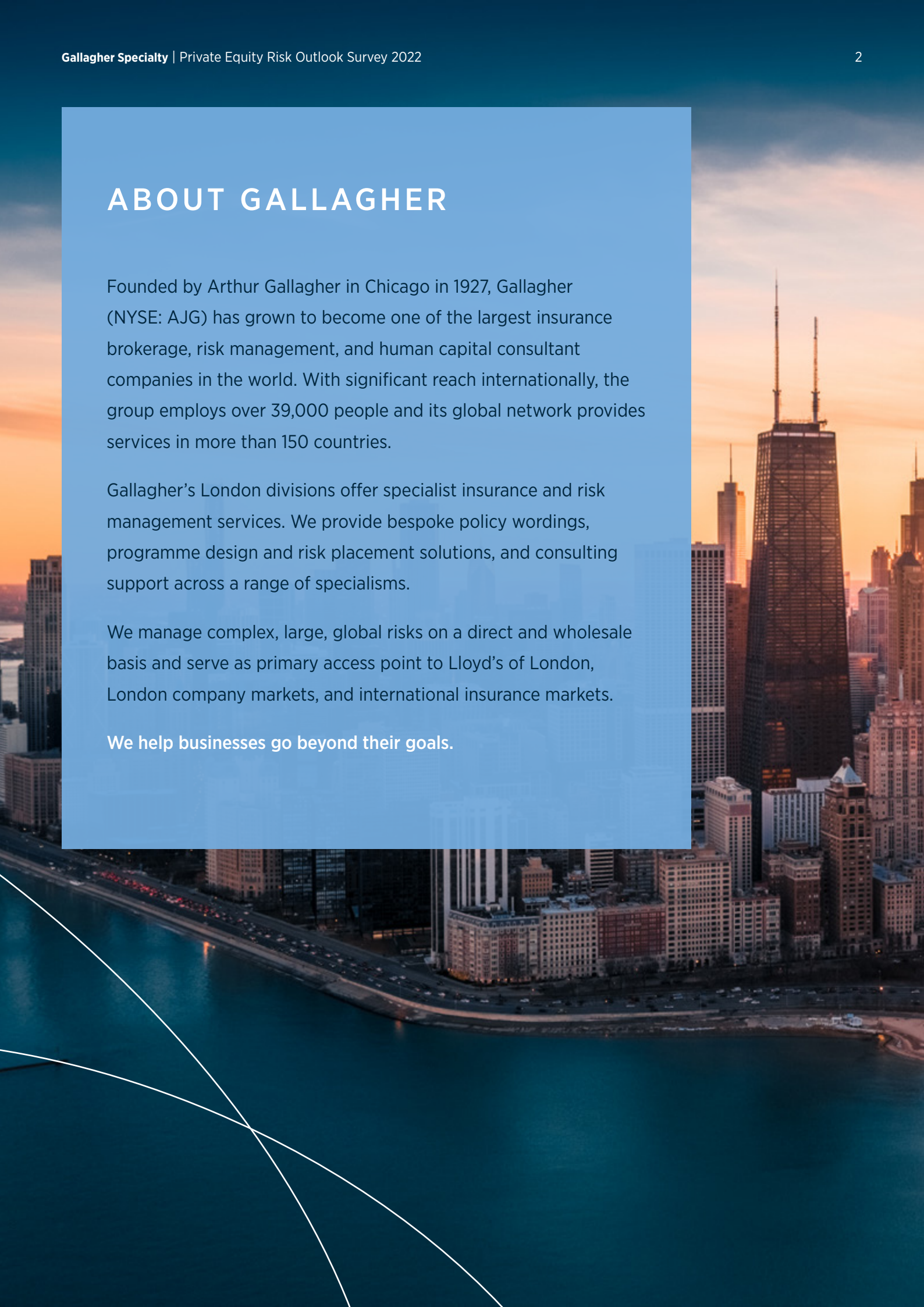
ABOUT GALLAGHER

Founded by Arthur Gallagher in Chicago in 1927, Gallagher (NYSE: AJG) has grown to become one of the largest insurance brokerage, risk management, and human capital consultant companies in the world. With significant reach internationally, the group employs over 39,000 people and its global network provides services in more than 150 countries.

Gallagher's London divisions offer specialist insurance and risk management services. We provide bespoke policy wordings, programme design and risk placement solutions, and consulting support across a range of specialisms.

We manage complex, large, global risks on a direct and wholesale basis and serve as primary access point to Lloyd's of London, London company markets, and international insurance markets.

We help businesses go beyond their goals.



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Introduction

After a stellar 2021 for private equity, with deals hitting record highs despite challenging conditions resulting from post-pandemic uncertainty, we wouldn't have been remiss in thinking the storm had passed.

2022, however, has brought even more adverse weather. As governments continued in their attempts to deal with the aftermath of COVID-19, new and unwelcome factors have compounded the beleaguered state of economies worldwide. While some are the result of the measures of the last couple of years – border closures, manufacturing shutdowns, community lockdowns and other major disruption, the impact of which will be felt for some time to come – there were also fresh challenges.

Inextricably linked factors of supply chain issues, the Russia-Ukraine war, high energy costs and inflation have significantly impacted global growth – Fitch Solutions' January 2022 forecast of 4.1% growth (as cited in Gallagher's Structured Credit and Political Risk Insurance market update 2022) was downgraded to 3% in June 2022. But more than that, we're seeing global economies on the brink of recession. Market conditions are now more uncertain and volatile than ever, with geographic factors at play that are affecting investment trends and capital deployment.

So the landscape – as well as the risks – are more complex. But the outlook is far from bleak.

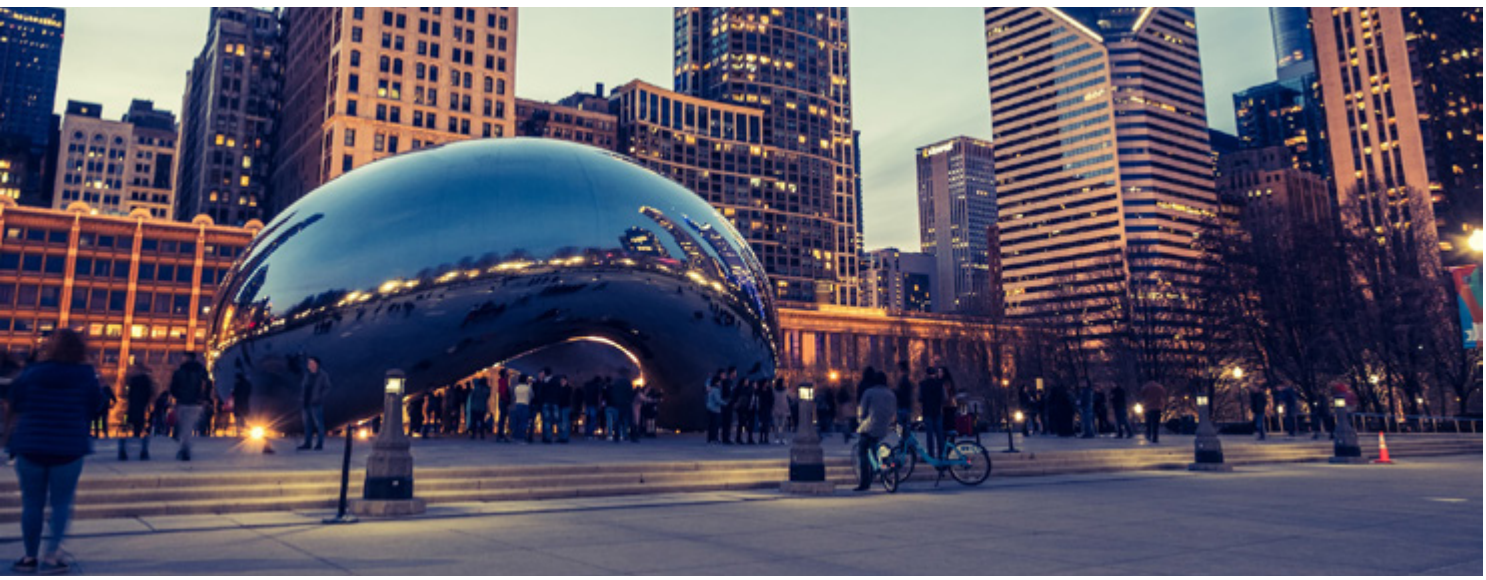
Preqin's 2022 Global Private Equity report quotes soaring deal and exit values and record amounts of investor capital. It counted 5,954 global private equity backed deals completed to October 2021, worth an aggregate of USD603 billion, which was already 28% higher than in 2020.

In addition, global private equity dry powder stood at USD1.32 trillion as of September 2021. How, where and when this capital is set to be deployed by yield-seeking private equity firms are the key questions.

In Q3 2022, Gallagher undertook research of 150 decision makers who manage investments at organisations with more than USD100 million value of assets under management (AUM).

These private equity firms across the UK, US and Singapore have given us valuable insight into their recent performance and strategic approach in the wake of exceptional circumstances. And how they use risk management and insurance to not only protect their portfolios, but also maximise investment value.

What we know is that adapting to new market dynamics, mitigating increasing risk and seizing opportunities where they arise are the biggest challenges for private equity firm managers. Collaboration with the right insurance partner therefore remains vital in understanding areas of exposure, minimizing risk, increasing resilience, and supporting successful future capital deployment strategies.



CHAPTER ONE

Market conditions and capital deployment: Global threats, regional opportunities?

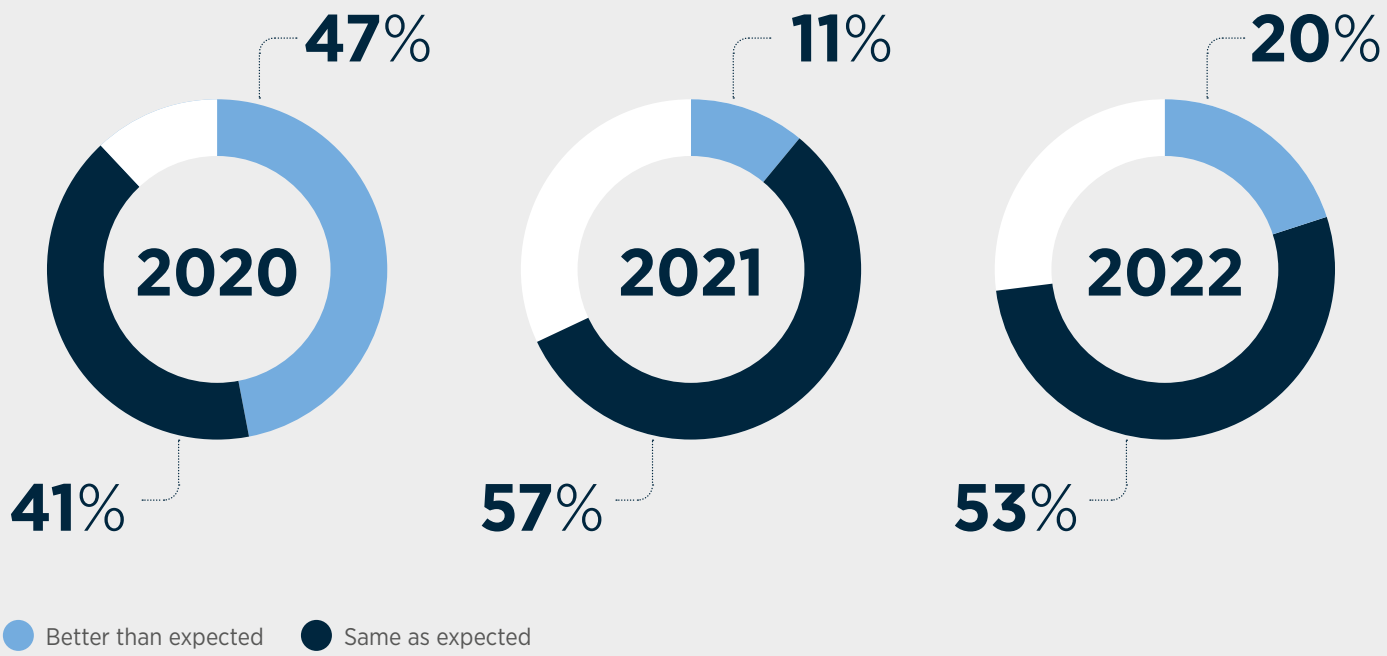
Private equity showing positive signs despite global challenges

On the back of an active year for private equity firms in 2021 that saw buyouts rise to USD1.1 trillion, and notable North American P2P deals including McAfee (USD15.4 bn), CyrusOne (USD15.3bn) and Proofpoint (USD12.3bn), the first half of 2022 has been, unsurprisingly, rather less stratospheric. Deal values declined by 18% and fundraising fell by 15% compared to the same period last year, according to EY.

While it's clear that market conditions continue to affect private equity firms' ability to deploy capital, there is some light. But there are stark regional differences. As we'll explore, these are largely due to the impact of the key factors of supply chain disruption, inflation, rising costs and interest rates, and the road towards environmental, social and governance (ESG), among other things.

In our 2022 Private Equity Risk Outlook survey, 73% of respondents stated that the outturn of the last 12 months was either the same as or better than expected – a slightly more optimistic overall response compared to 2021's 68%. Still a way off the 88% figure of 2020, but a move in a more positive direction.

Capital deployment – 3-year comparison



It's interesting to note the regional split here. Just 60% of US firms said the outturn was the same or better than expected; in the UK this rose to 72%; and in Singapore 88%. On the flip side, in the US, 40% said the outturn was worse than expected; 28% in the UK; and only 12% in Singapore.

The relative positivity among Singapore-based firms compared to the US and UK in responses related to outturn reflects the deal values we're seeing in the wider Asia-Pacific region, of which Singapore is a critical hub. Investments topped USD296 billion in 2021, up from USD198 billion in 2020. Indeed, at the end of 2021, the share of global AUM in Asia-Pacific increased by 30%. And over the last decade, AUM grew 2.4 times faster than North America and 3 times faster than Europe.

As we'll see, despite all regions suffering from the same current economic challenges, responses by governments to minimize the impact of the factors at play have been variable. And for investors this is critical.

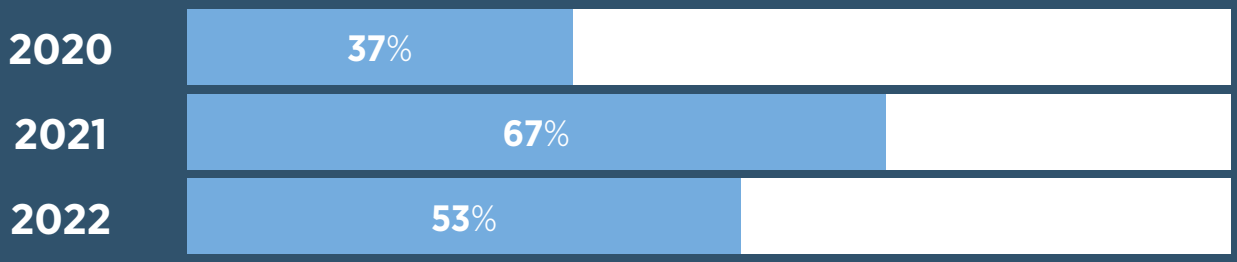
Deployment potential working its way back to pre-pandemic levels

As we would expect given the massive social, economic and political developments over the last two to three years, all respondents stated that market conditions have impacted their investment strategies in some way. In our 2022 survey, 53% of firms said market conditions over the last 12 months had prevented their business from deploying capital. This is down from the 67% that reported the same in 2021, but still a way off the 37% that said this was a factor in 2020.

As with the outturn, the regional split is also significant. While 53% globally said their ability to deploy capital was impeded by market conditions, the difference in regions was acute. UK and US firms have been more affected (62% and 58% respectively), while once more Singapore seems less scathed (40%). In fact, 50% of Singapore firms stated that market conditions have encouraged them to deploy more capital (while only 22% and 24% say the same in the UK and US respectively). 50% of Singapore firms also say market conditions have changed their geographical weighting – closely followed by the US (44%) and the UK (36%).

The conditions overall, therefore, are better for deploying capital according to the responses to our survey compared to 2021 – and working their way back to levels we were seeing pre-pandemic.

Capital deployment is bouncing back



Percentage of respondents that said market conditions prevented their firms from deploying capital during that year.

Three biggest threats to firms' portfolios:

1

32%

Rising inflation

2

31%

Supply chain crisis

3

19%

Climate change

When we look at responses to the question 'what is the largest threat to your portfolio?', it's unsurprising that rising inflation and the supply chain crisis are the two most prominent concerns for all private equity firms.

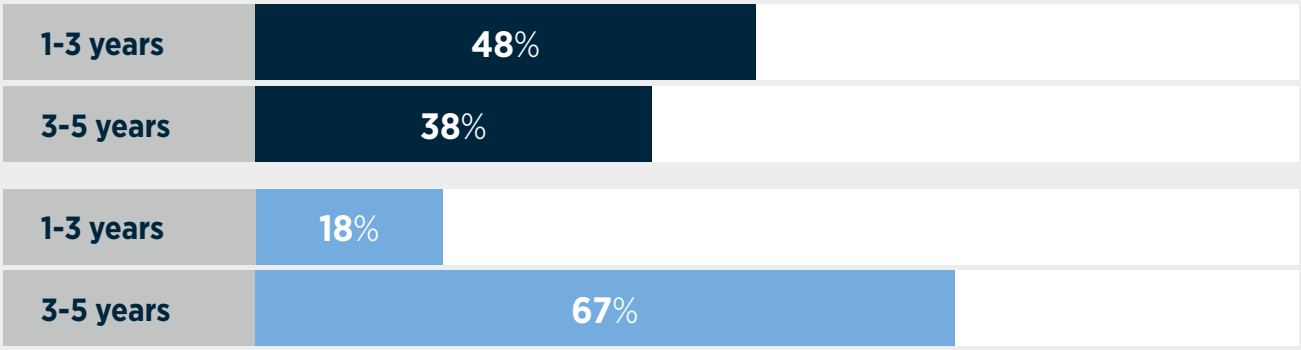
In the UK, ongoing Brexit trade barriers, domestic labour shortages, and panic buying have compounded the supply problems that are evident all over the world. This is seeing the cost of living skyrocket, with the consumer prices index (CPI) breaching 10% for the first time since the 1980s. Post-Brexit trade parameters with Europe have been difficult to establish, and supply chain issues are likely to be a significant hurdle for some time.

In the US, air and sea ports, roads, and railways have almost ground to a halt, leading to supply falling well short of keeping up with demand (which has been rising both during and post-pandemic). A USD1.3 trillion infrastructure bill announced by President Biden and aimed at addressing the major problems across the US' transport arteries has been slow to get through congress and put into action.

Singapore is heavily reliant on imports – 90% of its food, for example, is imported. This makes the supply chain an even more critical factor for this region. The Singaporean government has focused on a number of ways to address its supply chain issues throughout and post-COVID. From its Supply Chain 4.0, to the Singapore Trade Data Exchange, Southeast Asia Manufacturing Alliance, and the Regional Comprehensive Economic Partnership, the government is keen to apply technology and form agreements with local and wider partners to smooth supply chains. In addition, its pre-COVID trade wars with US and China may well have helped shape its focus on supporting businesses and encouraging investment through supply-chain robustness.

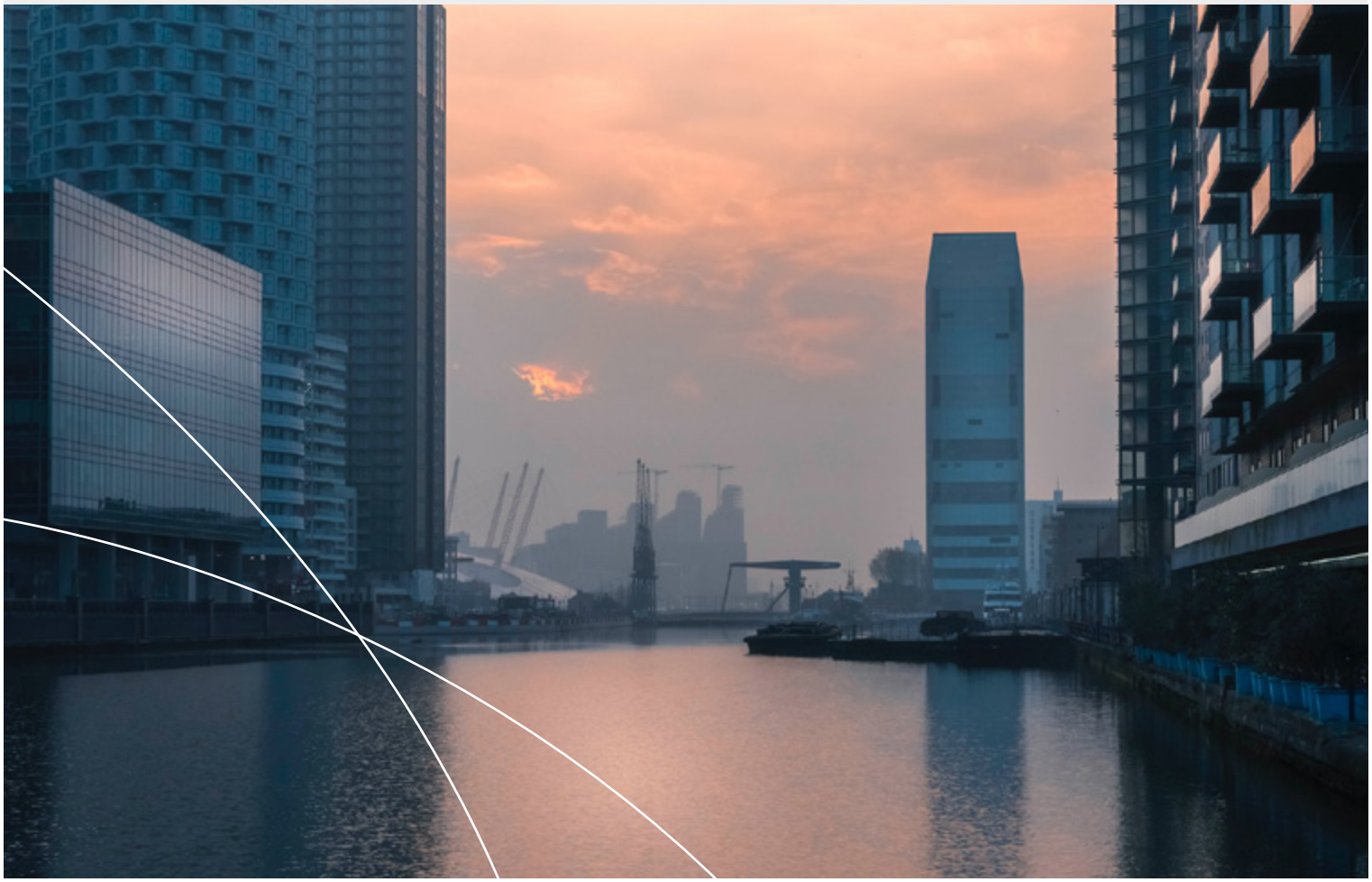
How resilient each region manages to be in the face of global and local challenges remains to be seen. And while government policies may not have an immediate impact on the flow (or not) of supply chains and spiralling inflation, investor confidence is acutely affected by action to both fix the current issues and mitigate against future disruption by building resilient strategies.

Overall holding periods



Holding periods are increasing, reflecting general uncertainty.

2020 2022



CHAPTER TWO

Industry focus: Sector exposure trends

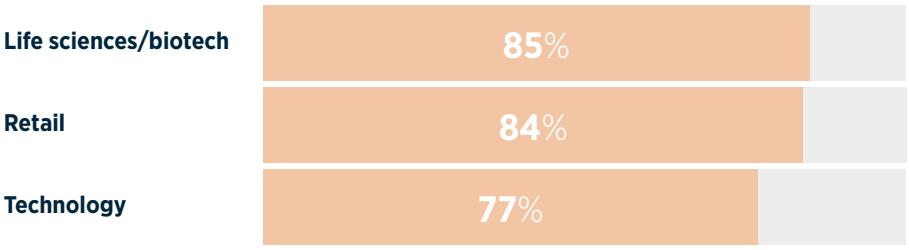
Tech remains top. But biotech sees massive upweight

Responses to our 2022 survey show that, unsurprisingly, technology remains top across the board, with 50% stating that their portfolios are weighted towards technology. This is followed by life sciences and biotech (39%) and financial services (37%). Technology is also in the top-3 of sectors most likely to be upweighted by firms.

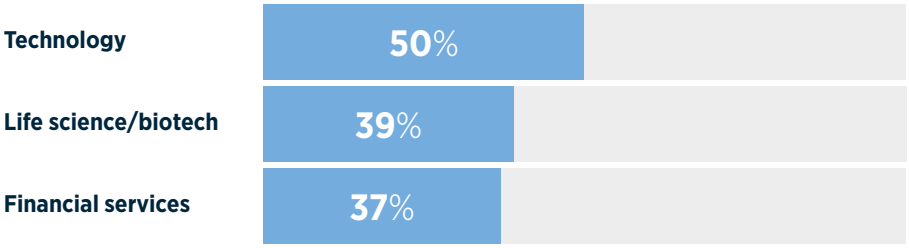
Perhaps equally unsurprising is that biotech replaced retail in second position in terms of current weighting. In addition, the majority of businesses planned to upweight life sciences and biotech, with 85% saying they intend to increase exposure over the next 12 months.

The pandemic effect at play? Certainly, the experience of the last few years has brought to the fore the importance of better, faster, smarter research, which can only be realised by leveraging cutting-edge technology in this area. Generally regarded as a high-risk, long-term investment play, it will be interesting to see if this upturn in life sciences and biotech materialises and/or endures.

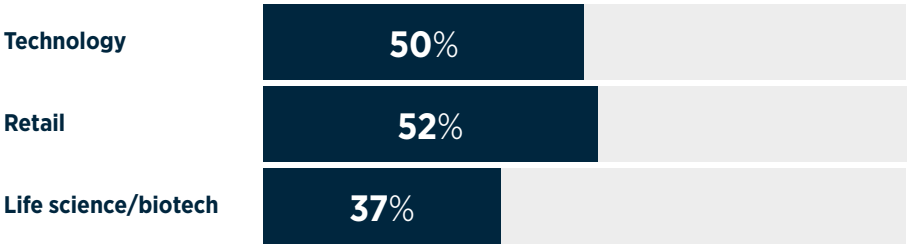
Sectors likely to be upweighted over the next 12 months



Top 3 weighting by sector 2022



Top 3 weighting by sector 2021



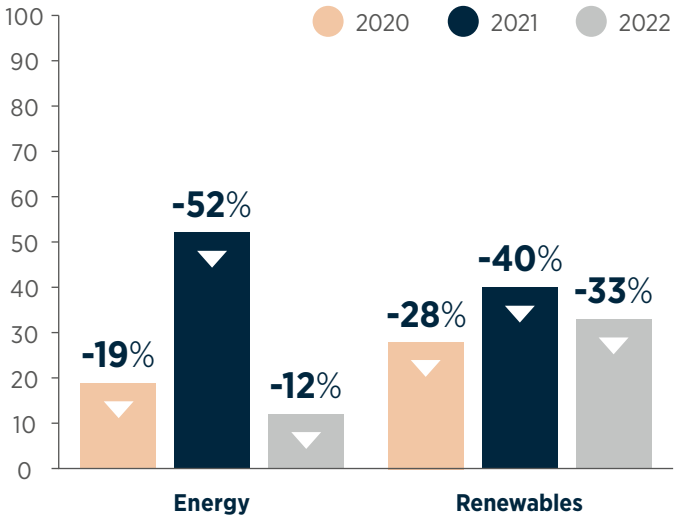
A surprising swap: renewables and energy

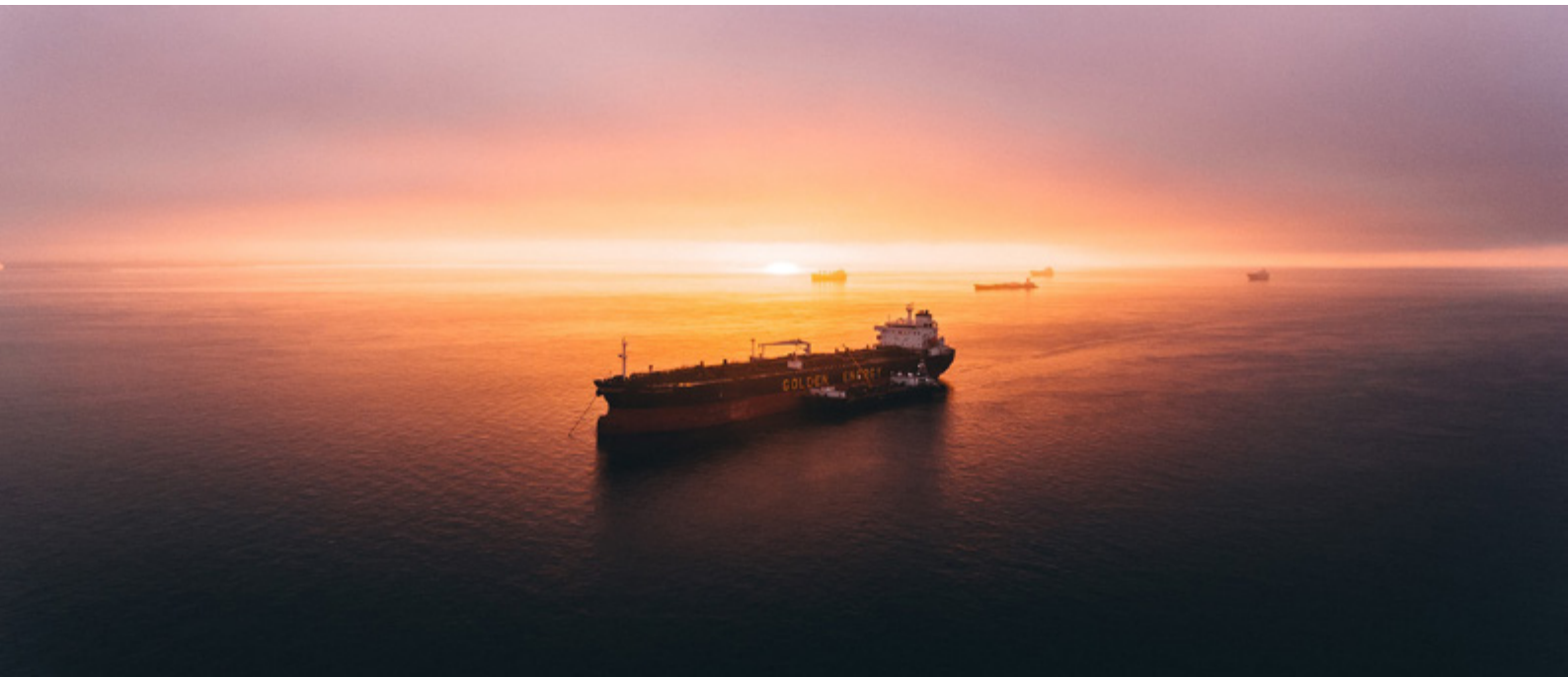
Despite the ongoing ESG focus worldwide, our results show greater upweight in energy (38%) compared to renewables (22%) in 2022. This is true in all regions, but especially marked in Singapore, where the percentage upweight was 75% compared to US (20%) and UK (28%).

Given Asia-Pacific's heavy and continued dependence on fossil fuels – coal represents almost half of the region's energy consumption – moves towards ESG investment will realistically be slower. And while regulation may be top of the agenda – as we'll explore in more detail in chapter 4 – this is unlikely to translate into concrete investment opportunity in the short-term.

Looking back at the global picture, a comparison of 2021 and 2022 responses shows significantly less down weighting of energy – just 12% compared to 52% in 2021. Less down weighting of renewables is also occurring compared to 2021, although arguably we would expect a more pronounced move in that direction. Our survey results therefore show a surprising trend, given that the green agenda, Net Zero and climate change initiatives are so much part of global government directives. Converting this into capital deployment may be a bigger global challenge than expected.

Energy and renewables – down weighting



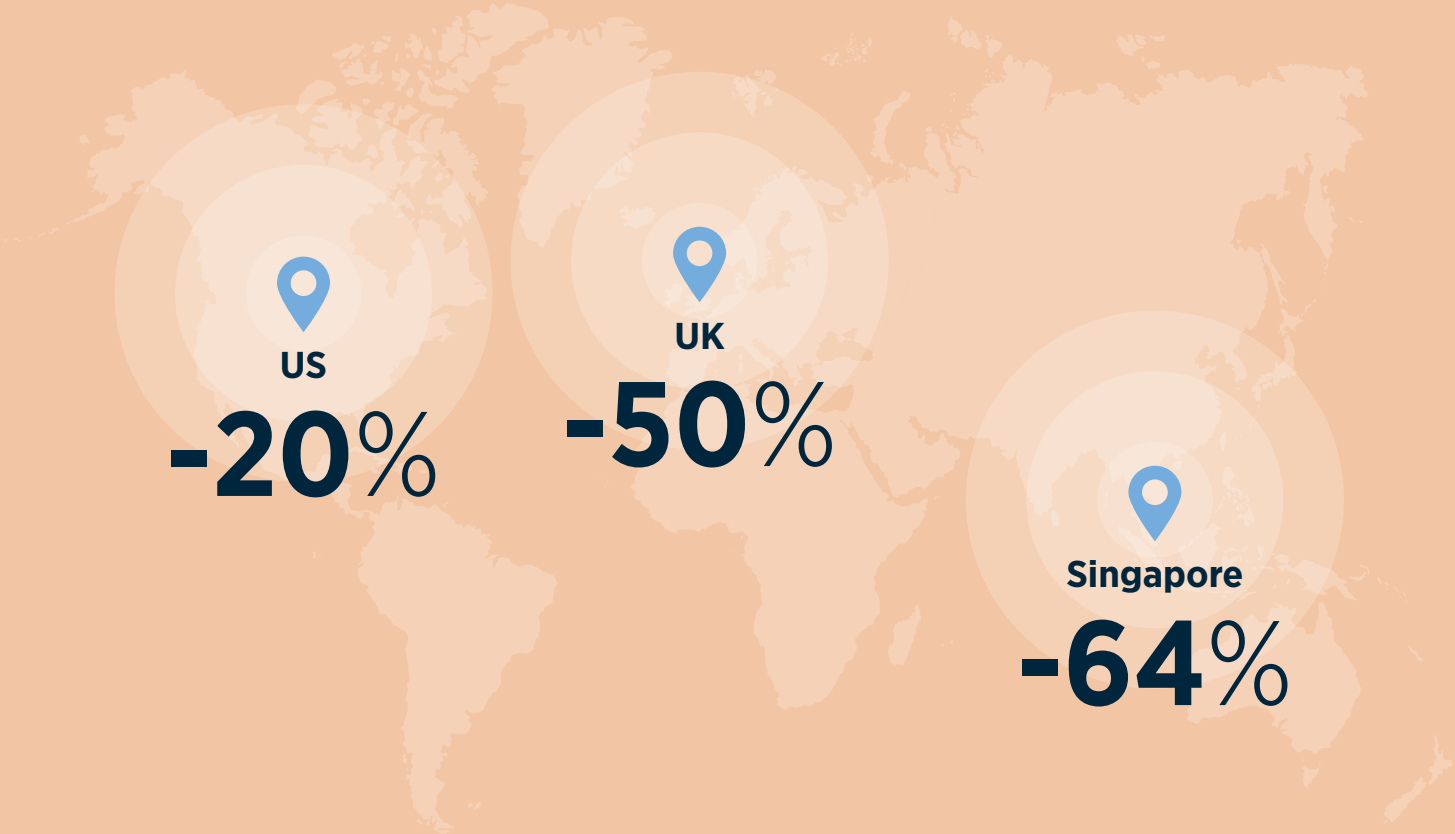


Substantial down weighting in real estate

Our survey results showed some other surprising, and not-so-surprising, down weighting trends. For example, while we'd expect leisure and hospitality to take a knock, the significant down weight in real estate in the UK (50%) and Singapore (64%) – although not in the US (20%) – is perhaps more unexpected at first glance. The UK and Singapore, after all, are real estate hot spots with investors that look both domestically and cross-border for deployment opportunities.

However, there are some key (and recurring) themes that likely account for the intent to down weight. Economic uncertainty, the continued changes in the real estate landscape post-COVID, (especially of commercial assets – office and retail), rising interest rates, and fears of global recession are undoubtedly factors that are having an impact on private equity firms' caution in this area.

Real estate down weighting, 2022

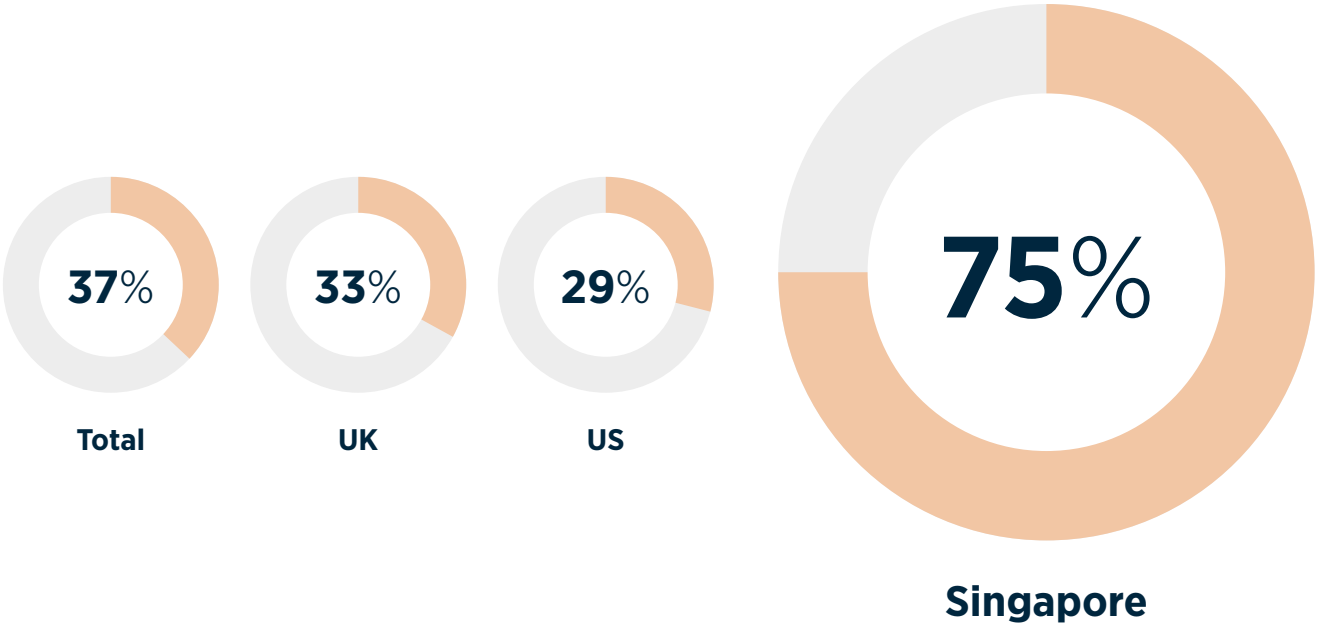


Singapore investors down weight industrials and manufacturing

The other noteworthy shift we've seen in our survey results is that of Singapore firms down weighting investment in industrials and manufacturing – to the tune of 75%. As a financial hub for for the wider Southeast Asia region, and a powerhouse of production, this an interesting response from Singapore-based private equity firms.

Manufacturing, however, has probably been hardest hit by the supply chain crisis, so divestment in this sector is more likely to be a short-term response to the ongoing issues. In addition, this down weight may be a possible reallocation towards technology: many Southeast Asian economies have been moving up the manufacturing value chain with a greater focus on semiconductors and nanotechnology.

Industrials and manufacturing: intent to down weight in next 12 months

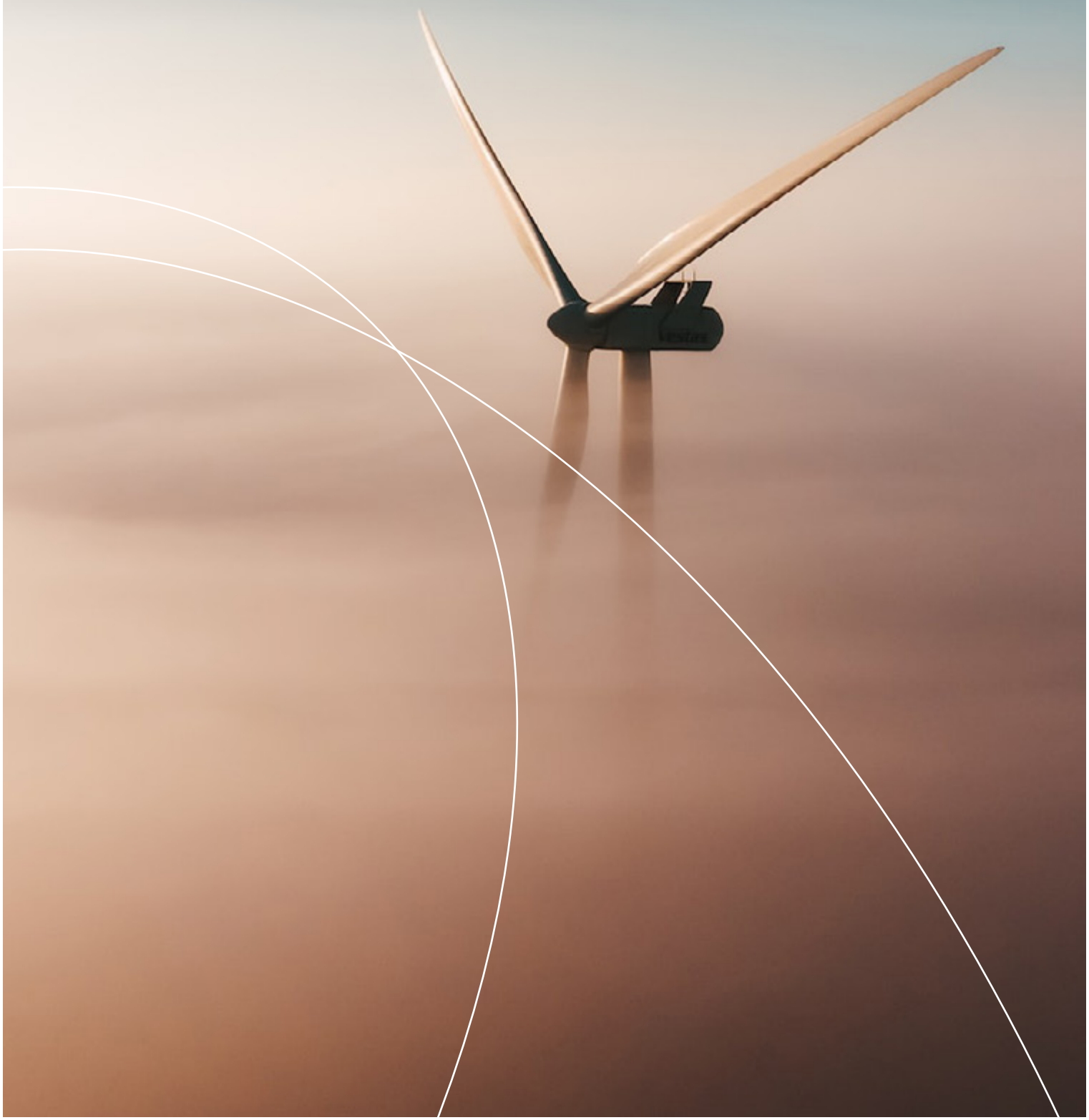


UK down weighting of financial services

Financial services – remaining in the top-3 weighting overall in 2022 and being either up weighted or staying the same in the US and Singapore – is being down weighted 12% according to our UK respondents. While not an overwhelming figure, it's still a significant shift that may, at least in part, be attributed to the reallocation of assets towards the life sciences sector – perhaps given the success of the UK's mRNA vaccines and other biotech developments. That said, it's not a departure we'd expect given the reliance of the UK on the financial services sector.

CHAPTER THREE

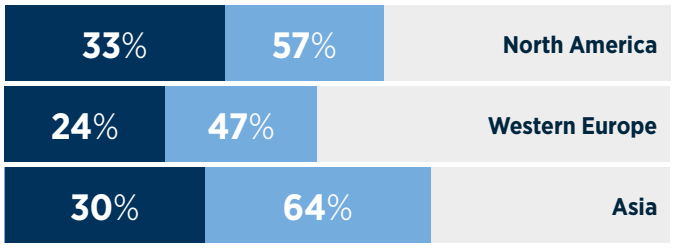
Geographic focus: Global investment trends



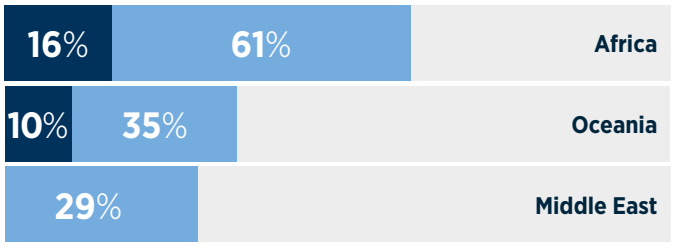
For 43% of the firms we surveyed in 2022, market conditions have impacted their geographical weighting. This represents a slight increase on 2021 (42%). While there's an obvious focus on home markets for each region – US (90%), UK (94%) and Singapore (98%) – private equity firms' plans over the next 12 months show intent to invest in Asia (64%), North America (57%) and Western Europe (47%).

With record funds waiting to be deployed and search for investment opportunities ever increasing, we would perhaps expect a focus away from developed markets to areas of greater potential – and potentially greater yield. This could be the result of a general decline in risk appetite globally, given the social, economic and political dynamics that have and continue to play out. The reasons given by respondents for reducing exposure in a market – lack of bolt-on opportunities, economic sanctions, and changes in regulation – seem to bear out that risk-taking isn't currently high on private equity firms' agendas.

Planned investment in the next 12 months, 2020 to 2022



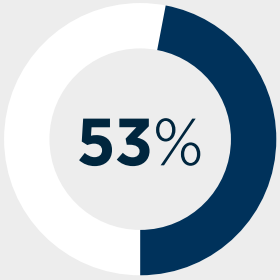
Planned divestment in the next 12 months, 2020 to 2022



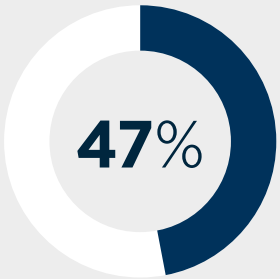
2020 2022

Main market drivers to reduce exposure or exit a specific region

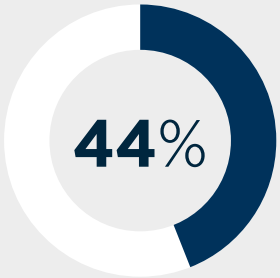
Lack of attractive bolt-on opportunities



Economic sanctions



Change in regulatory environment

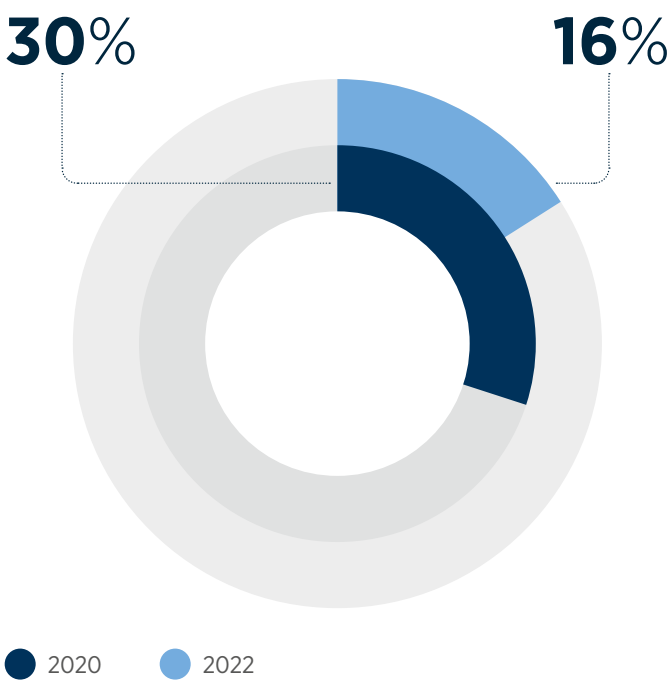


Central and Eastern Europe

This region is obviously in the spotlight due to the conflict between Russia and Ukraine, and so the changes in investment intent in this area are largely expected as an immediate response to unrest and uncertainty in the region. In 2021, 39% of private equity firms were looking to invest in Central and Eastern Europe, contrasted to just 16% in this year's survey.

Specifically, 69% of all respondents said the Ukraine conflict has influenced their investing or changed their priorities about investments in Eastern Europe. Unsurprisingly, the effect has been felt least in Singapore. While many of Asia's West-leaning economies such as Japan, South Korea, Taiwan, and Singapore have sanctioned Russia following the Ukraine conflict, many of their neighbours have been hesitant to follow suit: opting instead to balance ties between Russia and the West in the face of rising costs and matters of national interest.

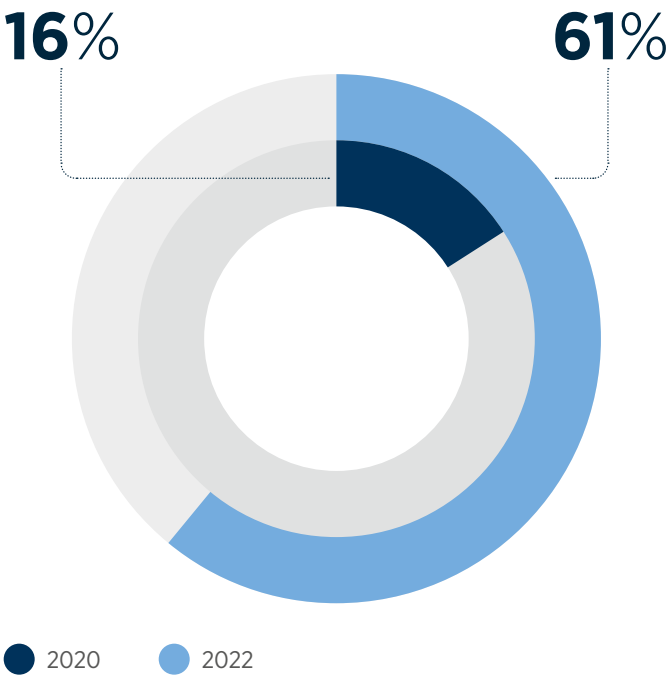
Intent to invest in Central and Eastern Europe, 2020/2022



Africa

Africa has seen the biggest increase in intent to divest: from 16% in 2020 to 61% in 2022. Despite being an attractive option for private equity firms – which have traditionally shown strong interest in fintech and, more recently, renewables in the region – there is relative lack of a strong track record and an elevated perception of the risk landscape due to a number of factors: legal and exit challenges, political stability and corruption continue to be hurdles for private equity investment in Africa. Perhaps combined with the larger issues that have impacted activity everywhere – the omnipresent supply chain disruption and pandemic effect – investment is looking less attractive in the short to medium term as firms increasingly reflect on and perhaps reconsider their risk appetite.

Intent to divest in Africa, 2020/2022



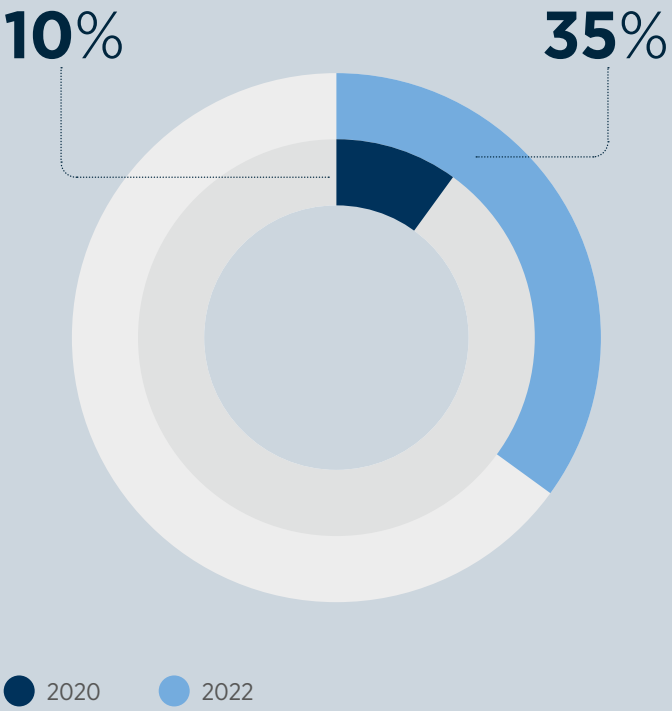
Oceania

Divestment in Oceania has been significant too. 2022's 35% active divestment plan represents a big shift from the 10% that was cited in 2021. Active divestment is strongest in US-based private equity firms – up from 24% in 2021 to 52% today. This is followed by an 18% to 44% rise in UK firms. As would be expected, the 2022 number is much smaller in Singapore at 10%. There's also intent to invest in the next 12 months from Singapore-based firms (24%) and UK firms (16%), although for US firms this is close to zero (2%).

Singapore's proximity to the region and the Asian trade agreements mentioned in relation to supply chains previously, are obvious factors in these differences in both divestment and investment intent.

The general downturn is likely in part due to the huge relative impact of pandemic measures, especially on trade and borders, exposing a lack of resilience in supply chains. While this was undoubtedly a global phenomenon, the measures and their ultimate effect were arguably more pronounced in countries such as Australia, which effectively closed its borders during the crisis. Here indeed, the government's own investigation into its pandemic response highlights the negative impact on supply chains, trade and investment.

Intent to divest in Oceania, 2020/2022



Middle East

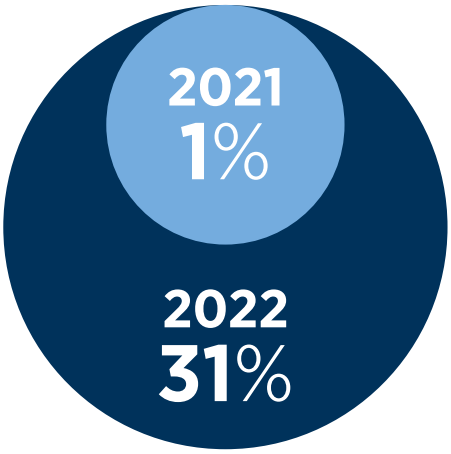
The Middle East represents an interesting region – with almost equal investment and divestment planned – based on all respondents, while 29% are actively divesting, a very similar amount (31%) are planning to invest in the next 12 months. However, the percentage stating they're planning to divest has decreased from 2021's 41%. While the investment figure has jumped massively from 1% in 2021 to the 31% in 2022. Importantly, it comes 4th in all respondents' investment plans for the next 12 months only after the main centres of Asia-Pacific, North America and Western Europe.

Planned investment by region over the next 12 months

	Total	UK	US	Singapore
Asia	64%	62%	36%	94%
North America	57%	50%	60%	62%
Western Europe	47%	54%	40%	48%
Middle East	31%	32%	32%	28%

Preqin points to a 52% increase in AUM over the last three years, with oil and gas prices being pushed up by the Russia-Ukraine conflict being a key factor. It's also noted that countries across the region have long been looking to diversify their economies to be less reliant on oil and gas. The fintech/startup sector specifically has been booming due to investment over the last few years – and with continued importance of tech investment across the board, this is making the Middle East an attractive area of potentially high/fast returns.

Intent to invest in Middle East, 2021/2022



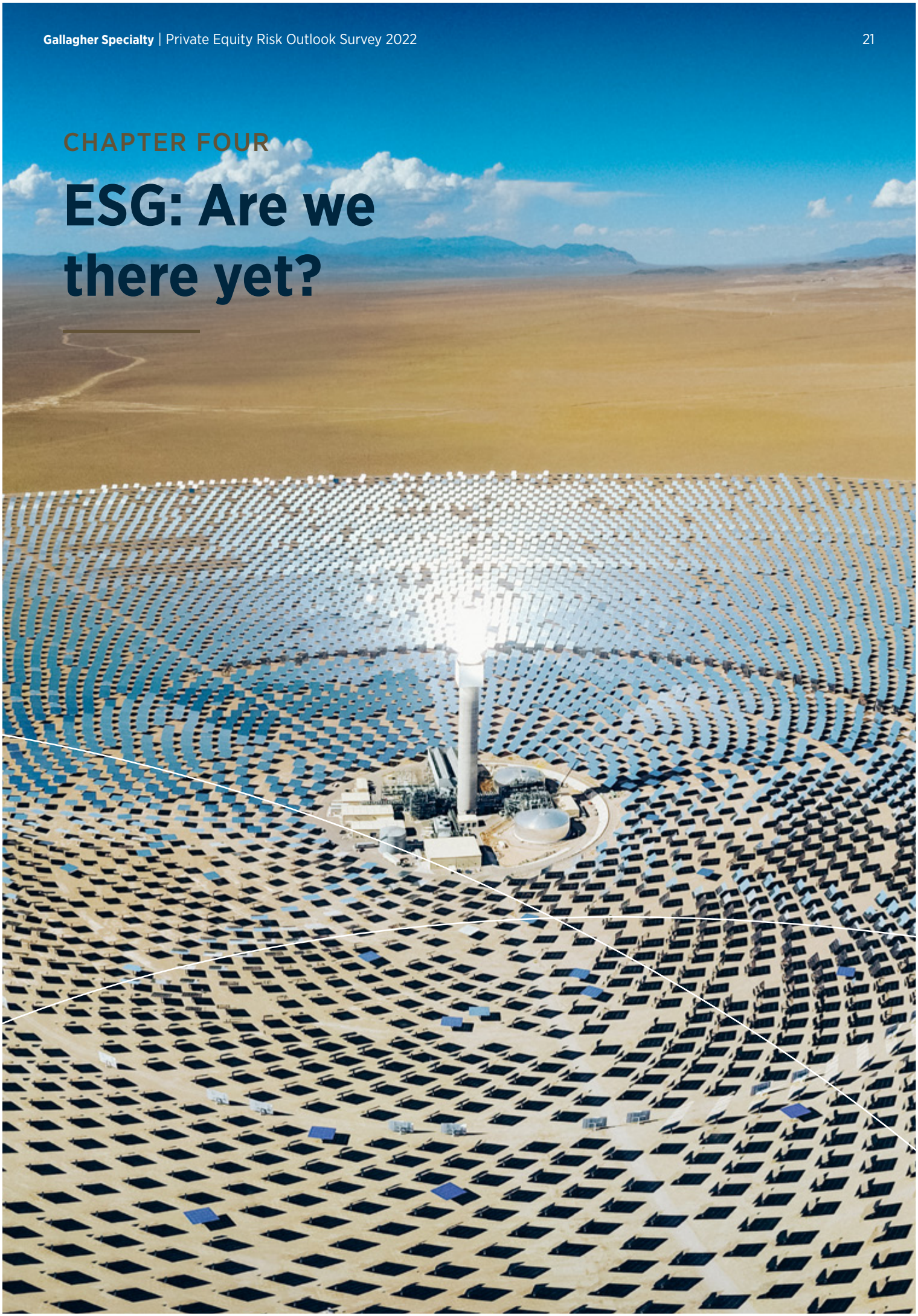
South & Central America

Notable in this area is the US's increase in investment: from 29% in 2021 to 42% in 2022. And 20% citing that they're looking to invest in the next 12 months.

With China's influence and investment rapidly increasing in the region – US16.7 billion in 2020, and nearly that amount just in the period from January to August 2021 – the US is looking to boost its presence and focusing heavily on infrastructure as well as renewable energy in order to compete with China and keep its traditional stronghold in South & Central America.

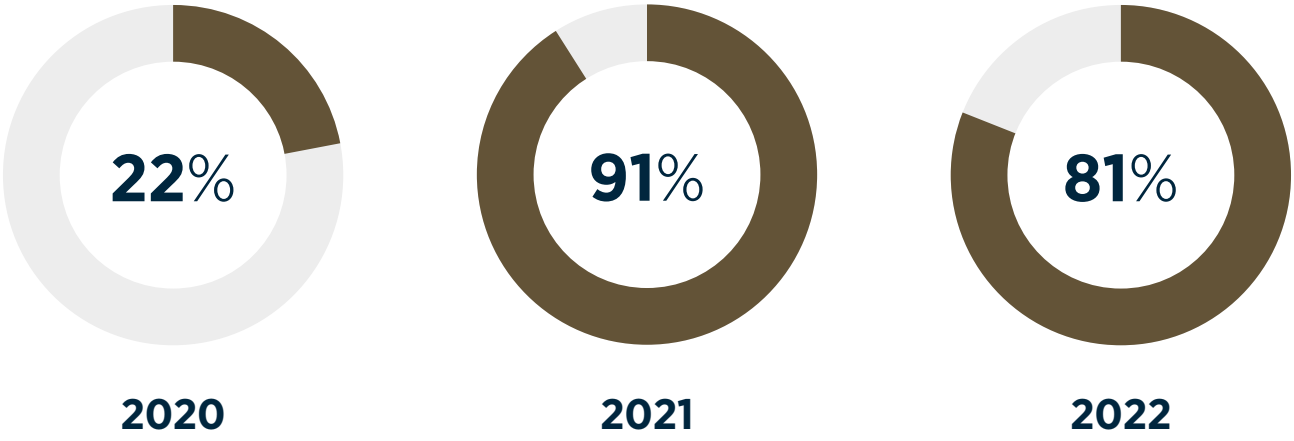
CHAPTER FOUR

ESG: Are we there yet?



More than four-fifths (81%) of private equity firms stated that the increase in ESG disclosure agreements is impacting their investment approach and strategy. This is a reduction in 2021's figure of 91%, but still a huge increase on 2020, where just 22% of respondents said the same. So the overall shift in this short space of time is significant. As the pressure (as well as hype) around ESG, especially post-pandemic, continues, however, there are a number of critical hurdles to increased investment in this area, as we'll see.

Increase in ESG disclosure agreements is impacting investment approach and strategy, 3-year comparison



Of the 81% that said disclosure agreements were impacting their investment strategy, 26% said it was due to the positive impact on investments, financial performance, and profits, and 17% said it was due to the effect on long-term success and the company's development.

The geographic split is worth mentioning too – 92% of firms in Singapore are feeling the impact of increased disclosure agreements, falling to 82% in the US and 68% in the UK.

Despite these significant figures across the board, it's interesting to note that 69% of all respondents do not avoid companies with a poor ESG rating and reputation – the highest percentage in answer to this question from Singapore-based firms at 80%.

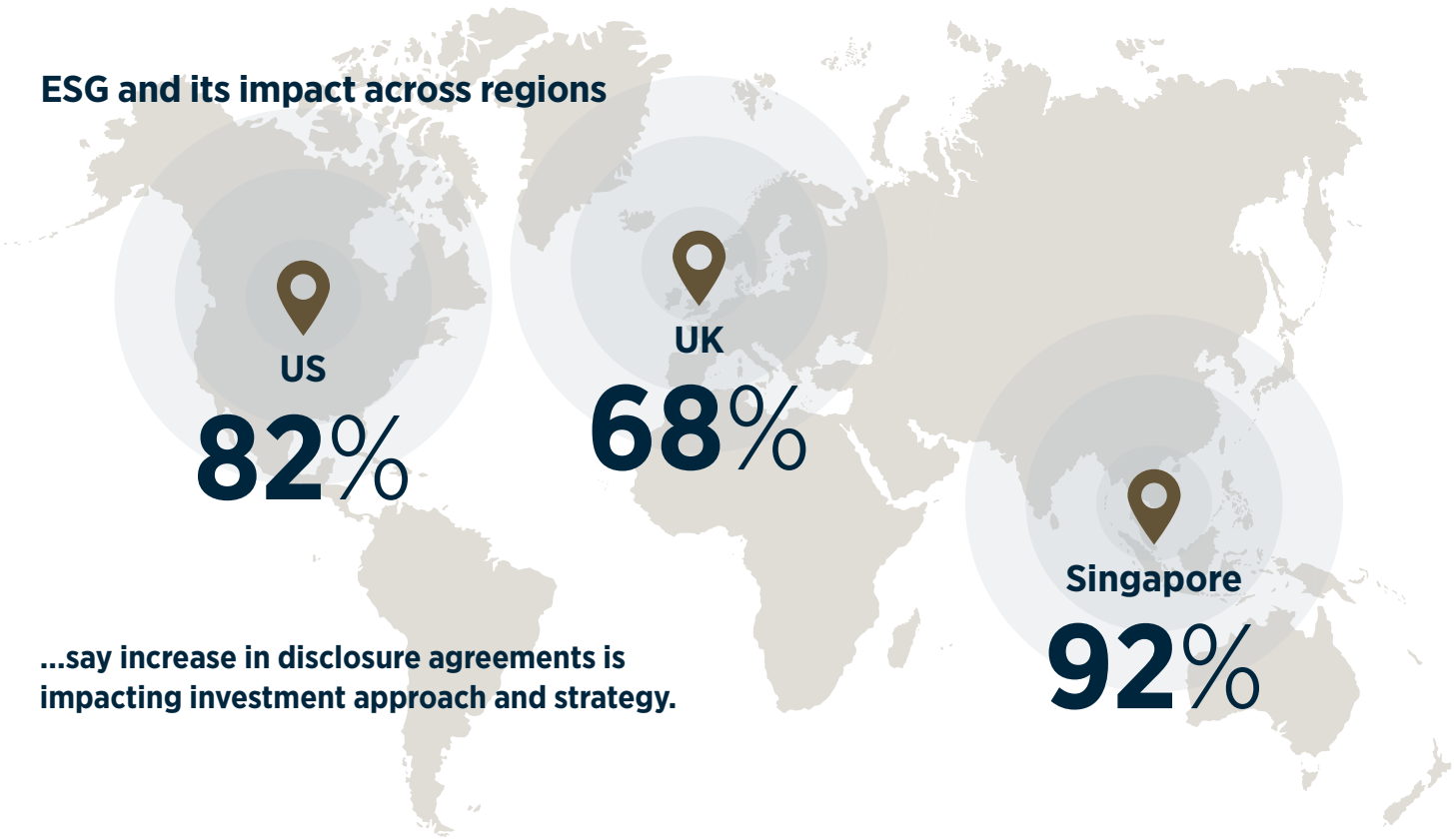
While these figures may seem counter-intuitive, the wheels of ESG – putting in place the right policies and businesses having the practical ability to act on and fulfil these – is a slow process. Simply put, good intentions are one thing – the availability (and feasibility) of realistic investment options is another.

In Gallagher's Infrastructure Investment Survey 2022, many of the 500 respondents reported that despite the fact their strategy is to prioritise ESG issues, there are considerable barriers to investment. A lack of return on investment was a particular concern – with this being most acute in Asia-Pacific, where 70% of businesses cited it as a barrier compared to 62% in Western Europe and just 54% in North America.

We can also look to regulation. Whereas regulators in Singapore and wider Asia-Pacific, have seemed to be proactive in ESG regulation, setting transparent standards and focusing on investor responsibility, this hasn't necessarily been the case in the US or UK. Again, Gallagher's Infrastructure Investment Survey highlighted a lack of government regulation in North America as cited by 43% of respondents in that region as to why they are failing to invest more in ESG. A criticism also levelled at the UK and highlighted in a recent survey by broker HYCM, which found that just 31% of 857 UK-based investors think the UK government is doing enough to encourage green and ESG investment.

Worthy of note also is the limited availability of sustainable materials as the second-most significant barrier to ESG investment as cited in our Infrastructure Investment Survey. It's a factor that's inseparable from ongoing supply chain issues and rising costs, and for this reason is a growing concern across all regions, as well as being a major consideration for private equity firms when looking to deploy capital.

ESG and its impact across regions



...say increase in disclosure agreements is impacting investment approach and strategy.

69% of private equity firms globally do not avoid companies with a poor ESG rating and reputation, rising to 80% in Singapore.

Conclusion

It's clear that private equity firms are facing more challenging times than ever before. As this year has shown so far, navigating next steps for fund managers is going to be much more than just adjusting after the pandemic and getting down to business as usual.

In 2021, we thought this was going to be the big hurdle. But more was to come, as we now know.

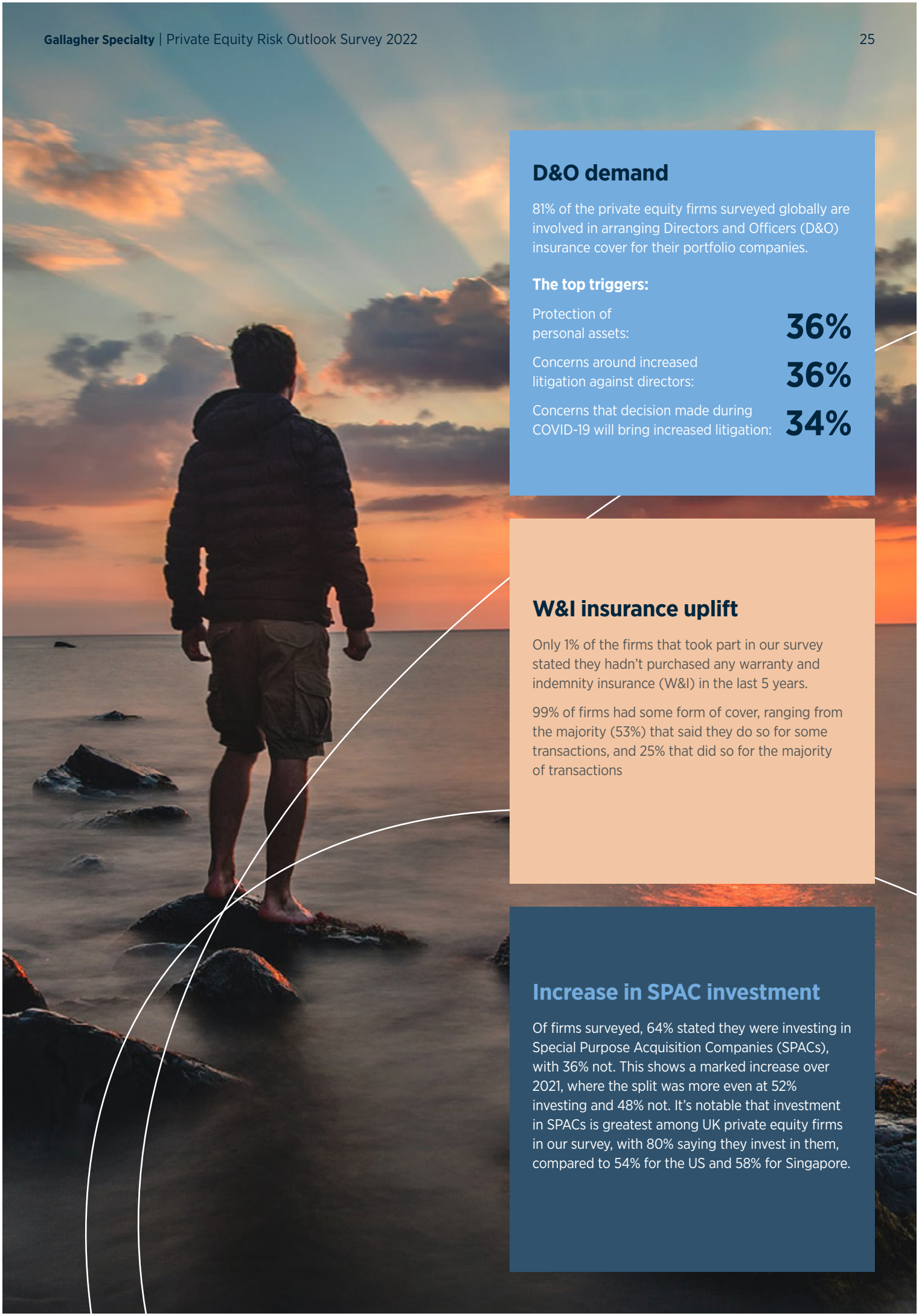
With the many factors affecting capital deployment that we've discussed – rising costs, ongoing global supply chain disruptions, ESG pressures – the risk landscape is significant, and the overwhelming feeling is that there is more to come.

But the hurdles aren't insurmountable.

Certainly, with today's fast-changing business cycles, inflationary pressures simmering across all major markets and the apparent dearth of high potential opportunities, firms appear to be taking an ever more cautious and selective approach to investments.

We know that resilience in the face of uncertainty is the key to success. And with the correct strategy and cover, private equity firms can increase their ability to operate in turbulent markets – and turn exceptional circumstances into opportunities for growth, capital deployment and high returns.

Choosing the right strategy, the right partners and the right insurance to mitigate risks and build portfolio resilience should be topping every private equity manager's to-do list.



D&O demand

81% of the private equity firms surveyed globally are involved in arranging Directors and Officers (D&O) insurance cover for their portfolio companies.

The top triggers:

Protection of personal assets: **36%**

Concerns around increased litigation against directors: **36%**

Concerns that decision made during COVID-19 will bring increased litigation: **34%**

W&I insurance uplift

Only 1% of the firms that took part in our survey stated they hadn't purchased any warranty and indemnity insurance (W&I) in the last 5 years.

99% of firms had some form of cover, ranging from the majority (53%) that said they do so for some transactions, and 25% that did so for the majority of transactions

Increase in SPAC investment

Of firms surveyed, 64% stated they were investing in Special Purpose Acquisition Companies (SPACs), with 36% not. This shows a marked increase over 2021, where the split was more even at 52% investing and 48% not. It's notable that investment in SPACs is greatest among UK private equity firms in our survey, with 80% saying they invest in them, compared to 54% for the US and 58% for Singapore.

For more information please contact

Amy Goldenberg
Business Development Director, Gallagher Specialty

Amy_Goldenberg@ajg.com

linkedin.com/gallagher-uk

specialty.ajg.com/private-equity/

All data unless otherwise stated from research conducted by Censuswide, on behalf of Gallagher, between 1 March and 31 March 2020, amongst Private Equity firms and houses based in the US, UK and Singapore, with 250 managers and above.

Conditions and Limitations

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