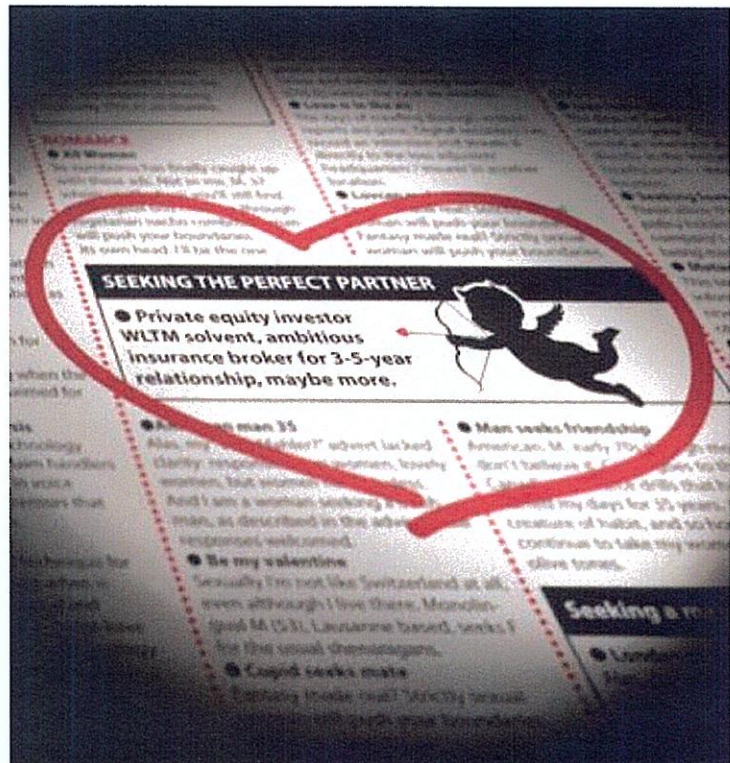


Matchmaker, matchmaker

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By Saxon East, Ben Dyson

Wealthy, daring, adventurous and assertive, private equity firms have plenty of the attributes you look for in a perfect partner. But as they cruise the insurance sector for prospective alliances, it's worth remembering that they can be fickle and demanding too ...

Feeling lonely? Looking for that special someone this Valentine's Day to help you realise your dreams or support you through difficult times? You are in luck. Private equity firms are scouring the insurance market for new partners. If you are a broker or service provider, so much the better.

Advent's £200m investment in Towergate as part of the broker's pre-flotation refinancing is a case in point. And there are plenty more investors on the lookout for the perfect match.

Companies such as Bridgepoint and Duke Street are believed to be doing the rounds, and Gresham Private Equity has made no secret of its ambitions to repeat the success it enjoyed with its investment in Giles by investing in specialist brokers. Another is this week's news that Guy Hands' Terra Firma is considering a bid for Chaucer.

But with premium rates continuing to slide in commercial lines and limited organic growth prospects on the horizon, why the sudden interest in the insurance industry? Is there a dark side to being involved with private equity? And could private equity's demanding nature put strains on the relationship?

Long-term commitment

Private equity has a long history of investing in all areas of the insurance business, from brokers and underwriters through to various industry service providers such as loss adjusters or outsourced claims management firms. Some of the industry's biggest names, such as Ace, were founded with private equity support.

The recent surge in activity has, in part, been influenced by the financial crisis. Private equity firms held on to their money in the uncertain times of 2008 and 2009, but are now ebullient. "Everyone is feeling more upbeat and you can't rest on your laurels too long," Connection Capital partner Claire Madden says. "If you aren't in the game at the right time, the market may move on, prices may go up and you won't get the attractive multiples you can at the moment."

After its period of caution, the private equity community now has plenty of money burning a hole in its pocket. "Our understanding is that there is an awful lot of private equity money still out there," Shore Capital analyst Eamonn Flanagan says. "It is three or five-year money that was raised in 2005 or 2007 and if it is not invested, it has to be returned."

The insurance industry is attractive to private equity investors because it has weathered the financial crisis relatively well. Insurers and brokers have suffered dwindling demand from individuals and businesses keen to cut their spending, but have avoided the failures and bankruptcies seen in banking and consumer goods, for example. People may be spending less on insurance, but they still need it.

"Some of the macro drivers behind our investment in [household claims management company] LAS are true for significant portions of the insurance industry," Gresham partner Simon Hemley says. "It is less susceptible to the economic downturn than many other sectors. If you take LAS as an example, there are about £4bn of household claims year in, year out, and damage to individuals' property will occur regardless of economic downturn or upturn."

Madden at Connection Capital agrees. "Margins probably have been squeezed in hard times, but it is a sector that has been relatively resilient throughout this period," she says. "The same cannot be said for quite a few companies."

Love at first sight

To the extent the industry has suffered, this has only made it more attractive to private equity investors. Valuations have fallen, allowing investors to pick up stakes in top-notch businesses at bargain basement prices.

"The opportunity to sell your business is still not that great at the moment – multiples are still not at the dizzy heights they were three or four years ago," Madden says. "Many business owners are taking the opportunity to release some of their wealth within the business – in other words, sell a minority stake to a private equity investor."

The UK broking market, especially, has several features that appeal to private equity. Although there is interest in buying underwriters, as shown by Achilles' purchase of Lloyd's insurer Brit, the lack of underwriting risk on brokers' and service providers' balance sheets makes them a more attractive proposition, especially for small to mid-sized private equity houses.

A big plus is that broking tends to generate a lot of money that comes in predictable patterns – perfect for non-specialist investors. "We get approached [by private equity investors] all the time," says Oval chief executive Philip Hodson. "Obviously, they want to invest at multiples that don't always suit us nowadays, but I think there is a lot of confidence in repetitive income in the broking market – it's very sustainable, as the whole insurance industry has been."

Another attraction for private equity investors is that, despite heavy consolidation in the sector, there are still large numbers of specialist small and mid-sized brokers looking to grow or become part of a larger group. "A benefit of being an investor in a fragmented market is that there will be buy-and-build and consolidation opportunities," Gresham's Hemley says.

"We are good at this and can add value in this area," he adds. "This approach can be extremely successful at growing businesses quickly. Giles is a good example."

A rapidly growing business is likely to catch the eye of a larger suitor, providing private equity investors with one of their must-haves for investment – an obvious exit route. "If you invest in a niche broker or a company looking to grow, then at some point one of the bigger players is going to take an interest in them," Madden says.

The consolidator model, as Advent's purchase of the stake in Towergate shows, is particularly attractive to private equity. They typically combine the vital ingredients of strong management, good growth through mergers and acquisitions and a clear exit route through an eventual flotation or sale to a rival.

Some private equity investors are even aiming to start their own consolidators from scratch. Hemley says that his company looks specifically at specialist brokers because they typically are clearly differentiated from

the competition, but also because there is scope to combine them. "That strategy would appeal to us because of the possibility of using a specialist broker as a platform, and then bolting on other, maybe smaller, specialist brokers and benefiting for cross-selling opportunities."

Relationship troubles

There are some indications, however, that private equity investors may not be the perfect partners they first appear. For instance, they seek specific returns over a set period – typically three to five years. As Hemley explains: "Three times the original investment is a meaningless target if you don't put some sort of timing on it."

This can put high pressure on management, and could result in a firm over-stretching itself or having to make sharp cutbacks to meet the targets of its new private equity masters.

The losers, according to some, are the staff. National secretary of the Independent Democratic Union (IDU), Alistair Maclean, says private equity companies will typically look to reduce costs through cutting jobs or reducing pension payouts.

The IDU ended a long-running battle with Acromas – the private equity owners of AA and Saga Insurance – last summer, which resulted in the group lowering its annual pension contribution for employees.

"They are ruthless," Maclean says. "They wanted to prune [the pension contribution] an awful lot more, but the unions helped prevent it. We didn't get everything, but neither did they. Had we not been there negotiating as a union, it could have been a lot worse."

Such cuts can leave a bitter taste in employees' mouths, Maclean says, when the private equity firms and company bosses pocket large pay cheques. "That money will not be spent in that local community. It will be taken away by them, and eventually converted into a huge amount of share value that they will walk away with."

Private equity can also be fickle. A hint of better returns elsewhere can tempt them away. Swiss reinsurance group Glacier Re closed its doors to new business in August last year because its majority owners, HBK Investments and Soros Fund Management, each with a 45% stake, decided to withdraw from the industry.

Getting to know you

As private equity firms often invest in a wide range of firms and are not sector specialists, their lack of specific insurance knowledge could be a concern. "They definitely need expertise to come in to help," KPMG partner Mark Winlow says. "Nick Prettejohn is a potential chairman for

Brit and they will make sure they have got the insurance expertise to complement management and their investment expertise."

Private equity firms say they are under no illusion about their relative lack of insurance knowledge. "What is common to all our investments is that we back strong management teams," Hemley says. "Ultimately, we are never going to be as experienced in the industry as our management teams. We are experts in private equity, they are experts in the insurance industry and we seek to work in partnership with them."

Private equity investors also insist that they carefully consider the effects on the company when setting targets. They say they recognise that running a company too hard can undermine its value and aim to ensure that, as far as customers are concerned, it is very much business as usual.

For Hemley, knowing how hard to push is all about experience. "Managing the growth in a controlled manner that will allow ourselves and management to achieve the returns we want without compromising the business, service levels and performance is something we are able to bring to bear through the experience we have gleaned over the past 10 years," he says.

He adds that, with the stake in LAS, Gresham has made investments in the business infrastructure and people to ensure service levels do not slip as the business grows.

For Madden at Connection Capital, managing expectations is key to ensuring harmonious relations. "When you invest you have to make sure you, the management team and the other shareholders share a vision for where the business is going and you are all working towards the same goal," she says.

Other industries may tempt private equity investors away, but some will always find a place for the insurance industry in their hearts. "The private equity community as a rule likes to invest in different sectors as this is beneficial in terms of managing our portfolio risk and opportunities," Hemley says. "Insurance will always be at or pretty close to the top of the list." **IT**