Market Economics:

How Higher Interest Rates are Affecting Private Equity Deal Flow for Brokers

Regardless of size, strategy or industry, nearly all private equity (PE) funds share a common reliance on access to debt for financing transactions. However, unprecedented rate hikes by the Federal Reserve over the past two years have impacted funds' access to capital and introduced new challenges into managing the balance sheets of their portfolio companies.

The Federal Reserve started raising rates in March 2022 and kept raising them through the end of 2023 as part of the central bank's aggressive plan to reduce inflation and steady the U.S. economy. At the start of 2024, the Federal Funds Rate sits as high as 5.5%, up significantly from 0.25% just two years ago.

In today's higher interest rate environment, companies taking on fresh debt or trying to refinance existing debts are faced with higher servicing costs affecting margins and profitability.

According to Reuters, these high interest rates, along with recession fears and a weak outlook for corporate earnings, have resulted in some of the lowest PE deal-making levels in four years. U.S. deal volume fell by half in 2023, with global markets seeing even steeper drop-offs. Exits have also sharply reduced, dropping from 281 in Q1 of 2023 to 247 in Q2, according to **KPMG**.

BEYOND PRIVATE EQUITY: THE IMPACT ON INSURERS AND BROKERS

These market effects are trickling down to the other players in the system: **the insurance carriers and brokers.**

Insurance Carriers. Increased interest rates have created two simultaneous forces working against each other as it impacts insurers:

1. Fewer transactions resulting in fewer new business opportunities for insurers targeting PE business. With a limited number of opportunities, the increased competition may cause premiums to go down.
2. Greater financial pressure on portfolio companies to service expensive debt, which could lead to increased bankruptcy risk. In response, risk tied to financial collateral, or the balance sheet may cause premiums to go up.

Brokers. PE-focused brokers are already tasked with the unique challenge of managing a broad set of exposures faced by a client's underlying portfolio companies, which may span several industries and require a variety of insurance products. Now, brokers must also face the additional pressure of securing coverage for portfolio companies that are potentially experiencing deteriorating financial conditions and increased risk profiles.

WIN-WIN-WIN SOLUTIONS

Collaborating with an insurer that applies a long-term view of the market and a holistic approach to a PE fund's broader portfolio allows brokers to tailor insurance solutions that not only protect their clients against risks but also contribute to the overall resilience and stability of their partnerships.

As a PE-focused carrier, we work with brokers to examine the broader portfolio exposures faced by PE funds and their investments.

Panel Strategy. Brokers and their PE clients want the same things: easy servicing, strong relationships, and economies of scale. Strategically partnering with a select panel of insurers offers a solution to address a wide range of portfolio risk factors while at the same time creating an easy way for brokers and carriers to target growth. We have extensive experience as a strategic panel partner for PE funds of all sizes. We can look at the entire portfolio and work strategically with brokers to match our solutions to their portfolio companies' needs. By utilizing a select panel of insurers, brokers can leverage scale, coordination and long-term stability, which helps deliver cost-effective and consistent results for their clients. Through these partnerships, PE firms can enjoy the benefit of working with a familiar set of insurers that are also more likely to write a tougher portfolio risk because of the broader relationship.

Data. Given the complexity of PE funds and their investments, timely and accurate information about underlying insurance programs and carrier relationships is imperative for brokers to compete for PE business. We have proprietary tools to quantify PE relationships across our organization to help identify and manage opportunities that are connected by PE. We add value by using this data to inform brokers of the totality of our PE relationships across lines of insurance, portfolio companies, industries and brokers. By understanding the holistic relationship, a broker can more effectively cross-sell and achieve favorable outcomes for all involved parties.

An Evolving Landscape

Doing business looks different for PE firms in 2024 than it did 16 months ago, but the market is cyclical. Brokers will need to help their clients navigate this new reality while guiding them through the related insurance challenges with a carrier that has withstood various market cycles. As a PE-focused carrier, we understand how to manage these cycles and bring expertise, coordination and transparency to the process.

Reach out to the Arch Private Equity team to learn more about what we do and how we can help.

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