Historically, private equity placements in the commercial surety marketplace have been challenging. In the past, underwriters had difficulty getting comfortable with these opportunities due to several key factors:

- The ultimate parent company’s (PE firm) unwillingness to indemnify.
- The substantial debt, as well as, material goodwill and intangibles that are typically placed on the purchased company’s balance sheet at closing.
- The general nature of PE firms divesting their acquisitions once reasonable returns and adequate profits are made on the initial capital contribution.

Today, much of the new business flowing into the commercial surety market is coming from PE-owned, or soon to be owned, entities. Sureties are still scrambling to become well-versed in underwriting this unique business model, so they remain competitive in today’s overall market. Lockton Surety Operations has seen an increased appetite for PE deals from many sureties—those outside of the top 10 surety providers. They have shown their willingness to dig into a deal and figure out a way to get it on their books. This has left some larger, slower to react top 10 markets outside of the PE business flow, as their underwriting approach typically mirrors their historically conservative approach on these deals.
Lack of Indemnity From Parent Company

The indemnity package is a major hurdle that needs to be explored and resolved, as the PE firm is usually unwilling to provide indemnity to the surety. In a typical non-PE commercial surety structure, the indemnity package consists of the ultimate parent company, possibly a holding company, and the operating entities that have bonding requirements. With the lack of ultimate parental indemnity availability in PE deals, the additional risk (in the eyes of the surety) lies in the potential upstreaming of assets to the ultimate parent (PE firm who is not providing indemnity). In a claim scenario, the PE firm could very well shift funds from the indemnifying entities in order to decrease the asset base the surety was counting on as part of its initial underwriting. The direct impact of the available indemnity can be seen in the terms posed.

Balance Sheet of the Purchased Company

The highest success rate of underwriting PE deals, with competitive terms, occurs right after the company has been purchased. In Lockton’s experience, PE firms typically retain a freshly purchased company for five to eight years. Sureties understand that PE firms are not going to extend considerable capital to purchase a company only to turn around and sell it a year or two later. This is comforting to a surety, as it knows the initially debt-heavy (large debt placed on the balance sheet at time of purchase) balance sheet and overall financial package should grow stronger as the debt is serviced, owner’s equity and revenues improve, intangibles are amortized, and cash flows increase with the capital and expertise provided by the PE backer.

Historically, Lockton saw companies being purchased with 70-80 percent debt and 20-30 percent cash. The debt service was so burdensome that companies could not scratch together enough money from their profit margins to pay the interest expense. This led to continual deficit net income figures, which hamper positive cash flow. Previously, it was not uncommon to have sureties require collateral, typically using an LOC, for 75 percent to 100 percent of the bonded exposure. Today’s transactions are typically less levered, with roughly 50 percent debt and 50 percent cash. In the sureties’ view, if the PE firm has more cash in the purchase, it is more invested in the success of the company. As well, the traditional PE opening balance sheet flip of the past is now curbed due to more liquid assets being placed on the balance sheet. Sureties love liquidity—a rarity in PE-owned companies. Lastly, companies have a better success rate at servicing the debt if there is 20-30 percent less debt on the books, which leads to better

Here are some items that surety companies like to see in a PE deal that make them more appealing to bond:

- "Low risk" type bond exposure
- Historically successful company prior to the PE buyout
- Management team stays intact after buyout to run the new company
- PE Firm has a balanced approach to funding the purchase (equal debt to capital contribution)
- Maintaining positive working capital and tangible equity after buyout occurs
- Strong business plan in place for the future of the new company
bottom-line results. With added liquidity and decreasing debt service, a surety is more comfortable with the fact that funds will be available for reimbursement in a claim scenario. We are seeing the surety programs written today with materially less LOC needed (0-50 percent) to back the surety exposure.

**Divestiture of Acquisitions**

Sureties love to hear the life story of companies they support including how experienced the management team is and its business plan for the future. Lockton has become proficient in explaining the key issues:

- Historical performance of the purchased company’s operations
- Why the PE firm believes the company will be a productive investment
- How the financials will gain traction to correct the upfront adjustments due to the purchase
- How the equity firm brings specific industry expertise to improve the company’s operations
- Why the surety’s exposure is more than covered by the financial wherewithal of the purchased company without the indemnity of the PE firm

Sureties love to hear why this deal makes sense, and why they are fools if they do not write the account.

However, there is a fine line between need-to-know information and nice-to-know information. Sureties ask for the moon in regard to information they “need.” It is our job to make sure they receive enough information to underwrite the deal, but weed out the nice-to-know information, so we are not overwhelming our client. As long as we have enough pertinent information to tell our clients’ story effectively, we should be successful in placing the business at competitive terms.

This is a perfect example for why the brokerage industry exists. We are here to be our clients’ consultant and advocate, tell the best story we can with the information given, procure the most robust surety program the market has to offer, and provide quality service once placed. This is a competitive time in the commercial surety marketplace, which has led to the revival of the PE deal placement.
Our Mission

To be the worldwide value and service leader in insurance brokerage, employee benefits, and risk management

Our Goal

To be the best place to do business and to work