howden
M&A

H1 2021 Spotlight Series

M&A Insurance

With global deal values at an all time high[1], H1 2021 has been an exceptional six months for everyone involved in the M&A market.

Given the shift in the M&A insurance market over that short period, Howden M&A has produced a review of H1 2021 to ensure our clients and partners are kept up to date with insurance market dynamics, particularly for warranty and indemnity (W&I) insurance.

Overview of H1 2021: a “perfect” storm

Even though 2020 was a turbulent year, Howden M&A saw an increase in deal volume and policy count. This was largely down to an exceptional Q4.

At the start of 2021, we had expected to see a slight drop in volume, as is usual at the start of Q1, but records continued to be broken. Like the rest of the M&A community, we saw extraordinary deal volume: not just compared against 2020 but against any other year in our history.

To put it into context, we placed 479 policies on 321 deals between 1 January 2021 and 30 June 2021. That is equivalent to:

- 82% of the number of policies placed in 2020; and
- 77% of the number of deals that we worked on across the whole of 2020.

Putting aside policy and deal count, one of the stand-out statistics for H1 2021 is that Howden M&A acted on transactions with an aggregate enterprise value (EV) of EUR 70 billion: that is almost EUR 6 billion more than our entire book of deals for 2020. Having placed policies on 14 mega-deals this year (vs 10 in the entirety of 2020), the average deal size has increased by 36% to EUR 221 million.

For Howden M&A, as well as the increased uptake of M&A insurance and wider adoption/use of innovative solutions, this success has been driven largely by deal volume and us continuing to increase our market share.

[1] Data taken from Prequin Quarterly Update: Real Estate Q2 2021 Tearsheet

Insurance premium rate changes

As we reported in July 2021[2], the lack of capacity in the UK W&I market during Q2 2021 drove up the average rates that were on offer for operational transactions. The same has been true across many of our European markets in H1 2021 which meant that we saw a 5.22% increase in the average rate of premium for operational deals across Europe, when compared to the 12 months to 31 December 2020. There was an uptick in the average rate for European real estate deals from 0.79% to 0.85%, which (as with operational deals) was driven by some regional variations.

Sectors

The sectors that performed well at the end of 2020 continued to perform strongly for us in H1, with industrial and logistics being our busiest sector for real estate. For operational deals, the most activity was seen in the manufacturing and industrial sector but technology was a close second.

Innovation

Innovation continues to be at the heart of everything we do. We have been working on some of the most complex deals in the secondaries market – one included a portfolio of over 100 underlying assets. That deal was our 7th secondaries transaction of 2021, utilising the "Q&A Approach" to due diligence and policy structuring that Howden M&A developed in 2019, and 11th since the start of 2020.

We are also seeing innovations around perfoming loan portfolios, forward-purchase transactions, the breadth of cover provided by tax insurance and the use of title insurance on operational deals.

Howden M&A

Our team grew by 25% in H1 2021 as we employed additional people to build out our business across EMEA, strengthening our expertise in the specialist product areas and launching a new insurance due diligence and advisory service. To ensure consistent levels of high service, and leading expertise, we are continuing to grow in H2 2021 and we are expecting to see many more people join the team in the coming months.

Given the growth experienced by our Singapore office, we are excited to include it in our reporting for the very first time. With a new office opening in Hong Kong, we are looking forward to building on our success in the region.

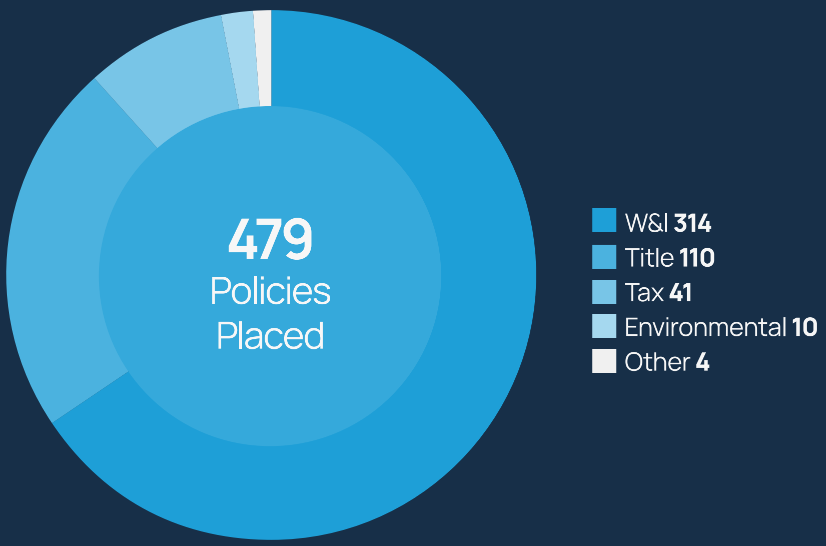
[2] Howden M&A, Private Equity sector update on M&A insurance market, available at: https://howdenmergers.com/news/pe-sector-update-on-ma-insurance-market/

Statistics

During H1 2021, we saw the number of non-W&I policies rise by 78% when compared against the same period in 2020.

This is a clear sign that insurance buyers are following on from one of the key trends of 2020 where insurance is being used more frequently to cover known issues.

The statistics section of this report will focus on W&I insurance rather than our specialist lines but please get in touch if you would like more data and insights on any of the specific risk insurance coverage.



W&I premium rates

In 2020, we saw a number of policyholders pay additional premium to take out enhancements on operational deals such as 'tipping to nil' deductibles. Looking at H1 2021, such enhancements have not been offered or not taken out as frequently. As such, some of the local rate reductions mask the fact that, in real terms, some rates have stayed the same or risen slightly.

If we put a lens on French real estate transactions, for example, the significant rise reflects the fact that most of the policies placed this year have covered at least one tax risk affirmatively and/or enhancements such as non-disclosure of due diligence have been taken out at additional cost.

APAC has been bucking the general European trend: increased competition and new entrants coming into the APAC insurance market has led to rates dropping considerably.

Given the nature of this high-level report, we cannot provide context behind all the data but our local experts would welcome a conversation with you to talk through that level of detail.

	Operational			Real Estate		
	2020 Rate	2021 Rate	Change[3]	2020 Rate	2021 Rate	Change[4]
United Kingdom	1.17	1.25	6.84	0.69	0.70	1.45
DACH	1.29	1.31	1.55	0.85	0.78	-8.24
CEE	1.21	1.25	3.31	1.03	0.82	-20.39
Benelux	1.20	1.23	2.50	0.65	0.73	12.31
Nordics	0.98	0.94	-4.08	0.67	0.68	1.49
France	1.21	1.28	5.79	0.60	0.98	63.33
Iberia	1.07	1.33	24.30	0.91	0.85	-6.59
Italy	1.09	1.09	0.00	0.94	1.22	29.79
APAC	2.0	1.38	-31.00	1.60	1.28	-20.00

data shown as a percentage (%)

1.21%

Average RoL across Europe for all operational deals

1.23%

Average RoL across EMEA for all operational deals

0.85%

Average RoL across Europe for all real estate deals

0.89%

Average RoL across EMEA for all real estate deals

It should be noted that the pricing set out above for APAC is for APAC/European style W&I policies. If US style W&I policies are used, the rates will likely increase by between 50% and 100%, depending on the parameters of the transaction. The rates for APAC are also an average across all APAC jurisdictions.

[3&4] H1 2021 compared against the full 12 month period for 2020

Tax premium rates & insurer appetite

Notwithstanding the volatility of the last 18 months, the tax insurance markets remain extremely competitive with the tax business growing materially: in H1 2021, the team placed 41 specific risk tax policies, which is 70% of the total number of policies placed in the 12 months to 31 December 2020. We have also advised on a significant number of W&I policies where the tax risks have been covered affirmatively, showing that tax exposures are increasingly insured in M&A transactions, rather than using other means of contractual risk allocation.

In this competitive landscape, insurers are typically seeking risks in the £10 million to £50 million range, albeit in recent months we have placed cover where the exposure is less than £1 million and in excess of £100 million. Furthermore there continues to be a growing application of tax insurance outside of M&A transactions, with a variety of funding/repatriation, structuring, and "business as usual" tax risks benefiting from the mitigation of tax risks through insurance.

Unlike the W&I market, pricing for tax cover has remained favourable for those seeking specific tax risk insurance, often pricing at less than 1.5% for tax risks that have robust fact patterns and supporting analysis.

Where the fact pattern is more complex – for example, 'forward looking' cover is sought, the policy interacts with a tax authority clearance process, or cover is placed on the sell-side insuring an indemnity given to the buyer – extra time should be factored into the process to obtain terms, ideally allowing two weeks from initial broker enquiry to a placed policy. Pricing is typically higher for risks of this type.

To support the growing appetite for our tax insurance advisory services, we have invested further in our tax team and we now have local tax expertise based in the majority of our European offices. Through this network, Howden M&A now has a unique pan-European tax insurance offering.

Our local tax expertise:

The insurance market can use deductibles, as well as premiums, to adjust its exposure to risk

Operational

Interestingly, those sectors that have seen a higher claims rate in the past six years, i.e. manufacturing and industrial, have seen a rise in the average level of deductible. Those that have seen fewer claims, such as financial and professional services, have seen a reduction. As predicted in our claims review paper[6] released in 2020, it would appear that the insurance market is starting to access its growing data pool to drive underwriting behaviour in a more meaningful way.

Like logistics, TMT has been a sector that fared well during the pandemic. These deals were sought after by insurers and the resultant competition for these 'sweet-spot' transactions drove the average deductible down even further in this sector, having already seen a 26.15% fall between 2019 and 2020.

Real Estate

Insurers are still willing to offer a nil deductible in most jurisdictions, even extending such terms to real estate deals in the residential sector, which mainly involved portfolios of residential assets in H1 2021, and the retail sector, where we placed more deals in H1 2021 than we did for the entirety of 2020.

With the logistics sector making up 42% of our real estate book in H1 2021, and the sector falling firmly within the appetite of M&A insurance underwriters, it is not surprising that the average level of deductible dropped from 0.01% to nil.

	2020	2021	Change[5]
Consumer	0.31	0.29	-6.45
Energy & infrastructure	0.40	0.31	-22.50
Financial & Professional Services	0.79	0.48	-39.24
Healthcare & pharmaceutical	0.36	0.37	2.78
Hotels	0.24	0.24	0.00
Manufacturing & industrial	0.46	0.49	6.52
TMT	0.48	0.31	-35.42

data shown as a percentage (%)

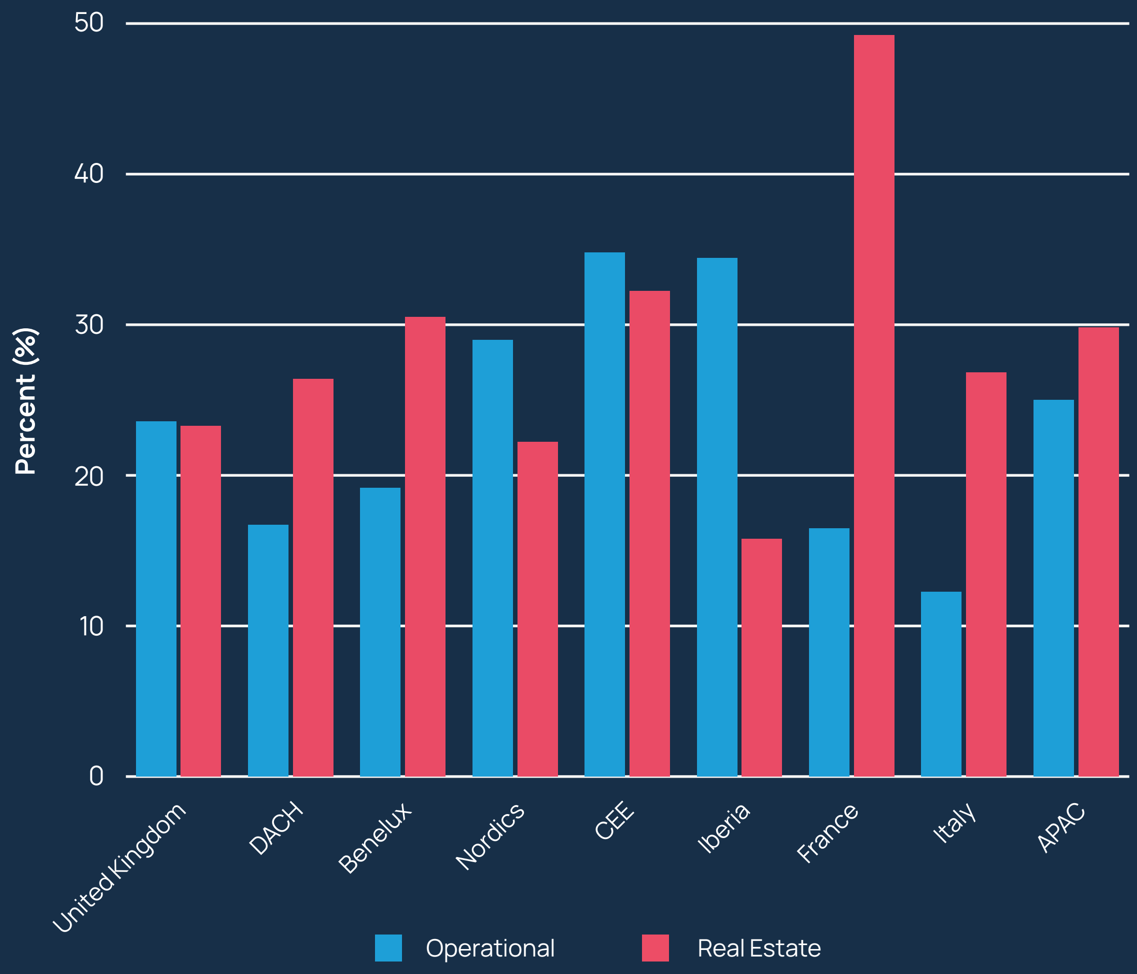
5 H1 2021 compared against the full 12 month period for 2020

6- Howden M&A Insurance EMEA Claims Report, available at: https://howdenmergers.com/documents/downloads/Howden_M&A_Claims_report_2020.pdf

Level of cover

We are continuing to see a rise in the level of cover obtained on W&I insurance transactions. Our view is that this is being driven by insurance buyers becoming more aware of claims and adjusting their exposure accordingly.

As with the W&I premium rates, the statistics need to be looked at in the context of the wider deal dynamics and/or insurance buying decisions. We are happy to share benchmarking data on a deal by deal basis but drawn from a finer set of data points that correlate to the underlying transaction.



Dealing with changing policy parameters

The recurring theme throughout this spotlight on H1 2021 is that the sheer volume of M&A activity has led to resource constraints in the M&A insurance market, particularly on operational deals. As we reported in our previous client updates on the subject[7], this has meant that it is now more difficult than it was historically to secure terms on deals not falling within the 'sweet spot' of insurance underwriters.

We have already highlighted the changes in pricing and deductibles but you also need to be aware of the following:

Across operational and real estate deals

1. **Insurer options:** where you might have had five to six insurers quote on a deal in the past, it is more likely that only one to three insurers will quote today. This is particularly the case for residential, retail and development assets, and operational real estate.
2. **Timing** – while previously it was the case that policies could be underwritten in one or two weeks of the underwriter receiving advanced due diligence reports, this process now typically takes a minimum of two weeks.
3. **Trees** – increasingly insurers are either refusing to offer trees or capping trees to a maximum of two.
4. **Policy limits** – the trend of insurers offering lower Policy Limits has continued, which means that more than one insurer is now often required to obtain policy limits above USD/EUR/GBP 50 million.
5. **Break fees** – underwriters have increased break fees charged to underwrite for non-exclusive bidders.

Across operational deals

1. **Multiplied loss and policy enhancements** – a number of insurers are now inserting express multiplied loss exclusions or limiting the maximum claimable multiplier to 12-15x EBITDA and starting to charge more for certain policy enhancements or not offering them at all, e.g. broader loss definitions, narrower disclosure definition etc.
2. **General exclusions** – The terms that are being provided for non-core deals are not as competitive as you may have seen prior to the current hardening of the M&A market and, depending upon the nature of the target, may well include carve outs for matters such as:
    - product liability and recall;
    - cyber;
    - professional indemnity;
    - condition of assets (not just condition of property); and
    - ABC/AML – insurers are applying more restrictive thresholds than before.

Even if product liability and recall, cyber or professional indemnity (as relevant) are not fully excluded, often cover is only provided on an "excess of and no broader than" basis, i.e. following the terms of the target's underlying insurance and only paying out once such policies are exhausted.

'Sweet Spot' operational deals

Competition remains high for those deals that are "sweet spot", with terms remaining similar to what was achievable before the market turned, albeit with fewer insurers quoting each deal.

"Sweet spot" deals are usually:

- in the technology, infrastructure, or manufacturing space;
- Enterprise Value of between USD/EUR/GBP 200 million and USD/EUR/GBP 700 million; and
- operations limited to a small number of Western/ Northern European countries, potentially with some limited exposure to the US/NZ/Australia.

Smaller deals (USD/EUR/GBP 30 million to USD/EUR/ GBP 100 million) continue to be quite straight-forward to place if the targets are predominantly located in the UK, France, Nordics, Germany or Benelux and the sector is considered favourable. Any other deals of this size are challenging to get placed.

[7] Howden M&A, Private Equity sector update on M&A insurance market, available at: https://howdenmergers.com/news/pe-sector-update-on-ma-insurance-market/ and Howden M&A, Real Estate sector update on M&A insurance market, available at: https://howdenmergers.com/news/re-sector-update-on-ma-insurance-market

Practical advice

There is a risk the market will not return to "normal" until either

(i) insurers reset budgets/limit caps in advance of their new financial year;

(ii) January 2022; or

(iii) new capacity enters the market, which is expected over the coming months.

We therefore advise you to get in touch with your insurance broker early for any upcoming deals – the more time insurers are given to quote/underwrite, the better your chances of securing terms and achieving a satisfactory cover position.

You should also leverage relationships, both via your broker and, if you place high volumes of policies with certain insurers, leverage those relationships via your portfolio companies.

Looking to H2 2021

As reported in our annual reviews of 2019 and 2020, we have been expecting a premium rate rise for W&I insurance. However, the current rate rise is being driven principally by the lack of capacity from a resource constraint point of view rather than claims experience. As capacity limitations ease, rates may stay the same, or rise slightly, to accomodate for the rising number of claims.

Our 2020 report predicted a rise in the use of insurance on take-private (P2P) deals. This will come but, given the capacity constraints in the W&I insurance market, that rise will likely be delayed as insurers will only be willing to take on 'vanilla' P2P risks, preferring to concentrate on their core areas of private M&A.

Neverthless, our involvement in secondaries transactions continues at pace. With a number of live mandates in process and in the pipeline, we expect significant growth to continue in this sector.

Within the first six months of 2021, each of our European offices had placed between 65% and 80% of the total number of policies bound in the entirety of 2020. We are therefore on course to see significant growth again this year.

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