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Mergers & Acquisitions

How will COVID-19 impact M&A insurance?

COVID-19 has seen financial crisis-style drops in public markets, bank debt markets dry up and M&A volumes drastically decrease. Notwithstanding this, some deals are progressing and with private equity investors sitting on $1.5t[1] of dry powder, it is only a matter of time before cash-rich funds seek opportunities to acquire undervalued and/or distressed targets. Many of these deals will require M&A insurance, but whether insurers will continue to have the appetite to provide the same broad cover of recent times at historically low prices remains to be seen. This note seeks to address the impact of COVID-19 on market dynamics, policy terms and claims.

Key take-aways

- The M&A insurance market remains open for new business;
- At present, pricing remains highly competitive due to insurers fighting over a smaller number of deals;
- Insurers expect thorough due diligence assessing the impacts of COVID-19, in particular on material contracts, supply chains and employment risks;
- We expect to see a spike in claims as insureds seek to recoup lost value;
- Insolvency/distressed transactions are anticipated to become the norm for a 6-18 month period with some insurers open to providing synthetic warranties on the right deal;
- A limited number of insurers are willing to consider insuring P2P transactions on a synthetic basis;
- Increased premiums are expected in the medium term as the spike in claims translates into payments; and
- Higher policy limits will be taken as insureds seek to de-risk transactions

COVID-19 impact on market dynamics

Open for business and improved pricing

The past fortnight has seen processes stall, pause or die at a rate not seen since the financial crisis. At Howden M&A, in the period immediately prior to COVID-19 we had 183 "live" projects. As of the 23rd March 2020, this figure had dropped to 60, with further processes likely to be placed on hold over the coming weeks. Despite these market conditions, deals that were close to signing have progressed and deals where targets are in resilient sectors (e.g. logistics and certain healthcare assets) are continuing. We have also seen the first enquiries, in what we expect to become a wave of requests, regarding insurance for distressed transactions. In contrast to the bank debt market, the M&A insurance market is continuing to operate, with pricing in fact *more* competitive than pre COVID-19 levels as the same number of insurers vie for a smaller pool of business.

Selective behaviour, capacity restrictions and mid-term price increases

In the medium term we expect insurers to become more conservative with respect to the maximum policy limits they are willing to offer on any given deal and more selective regarding the jurisdictions and industry sectors they are exposed to. While this should not affect the majority of transactions, large cap deals or those in non-core jurisdictions/industry sectors may struggle to secure the levels of capacity enjoyed in the pre COVID-19 world.

[1] https://www.bloomberg.com/news/articles/2020-01-02/private-equity-is-starting-2020-with-more-cash-than-ever-before

Even before the current market volatility, claims on M&A policies had been steadily increasing and some insurers were starting to implement price increases. This trend will likely be exacerbated by large insurers/reinsurers suffering material losses, both from the M&A claims that we predict will hit in the coming months and from their offering across broader insurance lines (particularly in the travel and event cancellation space). Insurers may decide they are no longer willing to be exposed to M&A insurance at the low prices buyers currently enjoy and the managing general agents (MGAs) may struggle to secure the same level of capacity when their current binder agreements renew (largely in December 2020). If this scenario plays out, early 2021 will almost certainly see price increases across the board for M&A insurance products.

Distressed deals and synthetic warranties

As distressed deals become commonplace, the M&A insurance market will have to shift its focus away from profitable/fast growth businesses and grapple with underwriting more challenging targets. While risks associated with such transactions are elevated and fulsome diligence is often difficult, sophisticated insurers will be able to adjust their approach — but are likely to require higher premiums and/or deductibles than we have seen in recent times. A limited number of insurers will also consider providing synthetic warranties subject to (i) detailed due diligence; (ii) an ability to influence the Q&A process to elicit quasi-disclosure; (iii) the warranty suite being balanced; and (iv) the target operating in a favourable industry sector and jurisdiction(s).

COVID-19 impact on policy terms

COVID-19 exclusion

The most immediate impact we are seeing on policy terms is the introduction of a new COVID-19 exclusion. In the short term, given that warranties always speak to historic matters and most deals see business warranties given at signing only, we will strongly push back against its inclusion. However, with the passage of time, this stance will become more difficult to defend so it will be vital to ensure the exclusion is drafted in a sufficiently narrow manner to avoid insurers using it as a back-door through which to side step claims.

Due diligence expectations and COVID-19 warranties

As one would expect, insurers are requiring robust diligence into the impact of COVID-19, in particular on financial forecasts, valuation, supply chain management, potential material contract dispute and employment matters. Warranties that one could previously secure cover for with relative ease, such as compliance with health and safety regulations and no material changes since the accounts date, are now being scrutinised heavily during underwriting, with insurers seeking to water-down these warranties or insert exclusions if the diligence does not provide sufficient comfort. Now more than ever the diligence scoping exercise is key to ensuring fulsome cover under W&I policies.

We are also seeing buyers place far more scrutiny on the target's insurance arrangements and whether business-critical risks are adequately insured. Securing cover for adequacy of insurance warranties has suddenly become a material point and will require an insurance due diligence exercise to have been undertaken, something only c. 50% of private equity firms currently do.

A buyer's market?

Our tentative view is that, at least in the short term, COVID-19 will signal a pause in the sellers' market and will hand back a greater degree of control to buyers. As a result, buyers may begin to place pressure on solvent sellers/management to stand behind the warranties, either entirely or to a more meaningful extent than has become customary over the last five years (i.e. €/£/$1.00). In turn, this could lead to an increase in the level of deductibles under buy-side W&I policies or even a demand for sell-side policies. In addition, we anticipate that buyers may be less willing to 'take a view' on known risks, especially tax risks, and look to the specific risk insurance market for protection (particularly in an environment where the financial stability of the seller may not be guaranteed or where the seller would rather pay for a policy than retain long-tail liability). That said, with the level of dry powder available to funds, in the mid-term a return to a seller's market seems inevitable.

With respect to transaction documents themselves, there is no doubt that MAC clauses will become a more common feature. From a policy standpoint, it will then be important to ensure that policies remain in force even if the parties agree to close following a MAC event (albeit any loss flowing from the matter which gave rise to the MAC event will not be covered under the policy).

We also expect to see increased use of deferred consideration / earn-out structures. From a policy perspective, the ultimate potential consideration should be taken into account when ascertaining a suitable policy limit, as opposed to rating the policy limit off the initial purchase price which may inappropriately restrict recoveries in the event of a claim. Furthermore, with a stronger buyers' market and continued turbulence, we anticipate that repetition of business warranties will feature more commonly in transaction documents. Whilst insurers are happy to provide cover for warranties repeated at closing, it will be key to include a bring-down mechanism in the transaction documents and to evidence that sellers have done a thorough job in updating disclosure. Securing "new breach" cover will be extremely challenging in the current climate, especially for operational businesses.

COVID-19 impact on claims

Increased claims

Economic downturns always lead to increased insurance claims as businesses look to mitigate losses. We expect the same to be true for M&A insurance, particularly as we have seen a general increase in the frequency of claims and pay-outs under M&A policies in recent years as insureds have become increasingly adept at navigating the claims process and demonstrated more of a willingness to bring claims against an insurer vs. management/sellers.

We expect a notable number of these additional claims to arise from material contract disputes. Whilst the COVID-19 outbreak is currently a post-signing event, buyers, their portfolio companies and indeed their customers will all be carefully reviewing material contracts to assess whether they have been complied with. It is likely that some of the issues identified will constitute pre-signing breaches, with insureds seeking recourse for these matters via their W&I policies. Such scrutiny would almost certainly not have been placed upon the compliance of these contracts had the COVID-19 outbreak not occurred.

With the safety net of employment contracts now looking significantly more attractive, contractors and other "non-employee" staff are also likely to assess closely whether they could qualify as employees in order to take advantage of the greater protection this status offers. Holiday pay and national minimum wage claims can be expected too, with such claims more common after dismissals. Accordingly, employment related claims (typically around 10% of total claims) could well increase in the coming months, albeit this risk may be mitigated somewhat by the planned emergency financial packages from governments across the Western world.

Evidence when applying multipliers

When claims arise, proving that a breach of warranty has occurred is often relatively simple, whereas evidencing loss (based on a multiple or otherwise) is usually more difficult. As insurers face more claims, they will be sensitive to what evidence exists to demonstrate how the target was valued. For example, if an EBITDA multiple is based on comparables in the market, and the market has rapidly shifted, it will be important to retain contemporaneous evidence of how the multiple was incorporated into the valuation model.

Policy Limits and insurer credit ratings

Even prior to the COVID-19 outbreak, several insureds who received large pay outs under their policies found themselves to be under-insured. This saw the beginnings of a trend whereby buyers secured 15-25% of enterprise value as a policy limit (vs. the historic norm of 10%). As a larger number of distressed transactions seek insurance and private equity funds commit a greater portion of equity to their transactions, we expect this trend to continue throughout 2020 and into 2021.

In line with securing larger policy limits and witnessing higher insolvency rates in the wider market, we anticipate that credit ratings will begin to play a larger role in the selection of insurers. Whilst all the insurers in the M&A insurance market are rated A- or higher, a stronger preference for the AA- or better rated insurers may start to play out. This will, of course, need to be balanced with the degree of cover offered by such insurers and the ease of their underwriting processes.

Conclusion

As outlined in this note, COVID-19 has and will present novel and evolving challenges to both the M&A and insurance markets. These challenges will need to be managed carefully to ensure M&A insurance continues to deliver the risk transfer that buyers and sellers have come to expect. At Howden M&A we remain ready and able to assist in meeting these challenges and solving problems as and when they arise. As is always the case, please feel free to get in contact with a member of the team.