A year of change

Mergers & Acquisitions Insurance
Howden 2015 insights
2015: a year of change

**Market forces**
2015 was a year of considerable change for the mergers and acquisitions insurance market. The continued increase in use of the product in the DACH region saw a number of insurers including Pembroke, ANV, Markel and Riskpoint strengthen their teams with hires of German underwriters. Incumbent players such as AIG and Zurich also bolstered their existing underwriting teams to accommodate the increase in demand.

We expanded our German operations, opening a dedicated DACH M&A insurance office in Frankfurt and hiring 3 individuals to the team including Pit Wadenbach as legal counsel and Gennadiy Kharif who previously spent 8 years at Citi Group’s German M&A practice.

This increased capacity resulted in a downward pressure on premium rates and deductibles, particularly on real estate transactions. More importantly, greater competition has provided us with opportunities to improve terms and secure policy wording enhancements for our clients. One such improvement is how ‘disclosed facts’ are treated for the purpose of the insured tax indemnity.

**Trends**
Correctly structured, W&I insurance provides private equity and real estate fund managers with a tool to achieve a clean exit and boost IRR.

In the real estate sector, there is a growing awareness of the potential tax exposures associated with offshore structures. German and international fund managers recognise the benefits of using W&I insurance to ring-fence such liabilities on exit and, as a result, over the last 12 months, we have seen the product become a firm feature of European deals.

In the private equity sector, financial sponsors have increasingly turned to ‘stapled’ insurance to support the sales process. Buyerside W&I insurance has allowed management’s liability to be capped at a low level which aligns the interests of management teams and selling sponsors. Buyers are then able to obtain meaningful contractual protection directly from an A-rated insurer.
2015 statistics

In the following pages, using data collected from the policies we placed in 2015, we provide an insight into the key W&I policy parameters.

The statistics are divided between deals in the real estate sector and deals involving operational businesses.

55% increase in the number of policies placed, supporting transactions with an aggregate value of €16.5bn across the private equity and real estate sectors.

€4.8bn value of deals worked on in the DACH region.
Policy limit
The policy limit is the insurer’s maximum liability for all loss. We typically place policies with a limit ranging from 10-30% of the deal value (but it is possible to insure up to 100%).

There was considerable variation of policy limits across sectors and asset classes – those involving operational businesses tended to be a higher percentage of deal value than those for real estate deals.

For transactions in the real estate sector, we have collaborated with title insurers and developed policies that provide cover for title to shares and property. These policies are a more cost-effective solution when limits of 100% of the transaction value are sought.

### Average policy limit as % of deal value

<table>
<thead>
<tr>
<th>Sector</th>
<th>Average Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Operational business</strong></td>
<td>30.57%</td>
</tr>
<tr>
<td>21.93% Media and Telecommunications</td>
<td></td>
</tr>
<tr>
<td>19.15% Consumer Goods and Services</td>
<td></td>
</tr>
<tr>
<td>28.21% Financial Services</td>
<td></td>
</tr>
<tr>
<td>19.62% Healthcare</td>
<td></td>
</tr>
<tr>
<td>25.19% Infrastructure</td>
<td></td>
</tr>
<tr>
<td>27.80% Manufacturing</td>
<td></td>
</tr>
<tr>
<td>45.20% Energy &amp; Utilities</td>
<td></td>
</tr>
<tr>
<td>35.71% Pharmaceuticals</td>
<td></td>
</tr>
<tr>
<td>36.87% Technology</td>
<td></td>
</tr>
<tr>
<td><strong>Real estate</strong></td>
<td>18.15%</td>
</tr>
<tr>
<td>11.98% Industrial</td>
<td></td>
</tr>
<tr>
<td>17.61% Logistics</td>
<td></td>
</tr>
<tr>
<td>19.38% Office</td>
<td></td>
</tr>
<tr>
<td>20.83% Residential</td>
<td></td>
</tr>
<tr>
<td>32.85% Retail</td>
<td></td>
</tr>
<tr>
<td>10.20% Hotels</td>
<td></td>
</tr>
<tr>
<td>48.03% Student accomodation</td>
<td></td>
</tr>
</tbody>
</table>
Deductible

The deductible (also known as the excess or ‘selbstbehalt’) is the aggregate amount of loss incurred before the insurer is liable to pay under the policy. There is a significant difference in the deductible level across operational businesses and those in the real estate sector – real estate deductibles are much lower and often ‘tip to nil’, allowing the seller to cap its liability to a nominal £1. On the contrary, deductibles for operational businesses are usually 0.5-1% of deal value and do not often ‘tip to nil’.

Whilst we regularly obtain deductibles of 0.1% (or lower) on German and Western European real estate transactions, the higher averages set out below reflect a significant number of South European and Asian real estate deals on which insurers have required a higher deductible level.

Although on deals involving operational businesses insurers generally require deductibles to be fixed to control moral hazard, we have negotiated zero seller or management recourse structures.

Average deductible as % of deal value

<table>
<thead>
<tr>
<th>Category</th>
<th>Average Deductible</th>
</tr>
</thead>
<tbody>
<tr>
<td>Media &amp; Telecoms</td>
<td>0.66%</td>
</tr>
<tr>
<td>Consumer Goods &amp; Services</td>
<td>0.77%</td>
</tr>
<tr>
<td>Healthcare</td>
<td>0.98%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>0.86%</td>
</tr>
<tr>
<td>Energy &amp; Utilities</td>
<td>0.99%</td>
</tr>
<tr>
<td>Technology</td>
<td>1.35%</td>
</tr>
</tbody>
</table>

Operational business average: 0.91%

<table>
<thead>
<tr>
<th>Category</th>
<th>Average Deductible</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial</td>
<td>0.44%</td>
</tr>
<tr>
<td>Logistics</td>
<td>0.37%</td>
</tr>
<tr>
<td>Office</td>
<td>0.40%</td>
</tr>
<tr>
<td>Residential</td>
<td>0.44%</td>
</tr>
<tr>
<td>Retail</td>
<td>0.41%</td>
</tr>
<tr>
<td>Hotels</td>
<td>0.34%</td>
</tr>
</tbody>
</table>

Real estate average: 0.41%
‘Tipping to nil’ deductible explained

- **Fixed deductible**: Once the aggregate amount of loss exceeds the deductible level, the insurer is only liable for loss above the deductible level.
- **‘Tipping to nil’**: Once the aggregate amount of loss exceeds the deductible level, the insurer will pay the entire amount of loss.

Deductible mechanics by nature of target

**Operational business**
- 83.33% Fixed
- 8.33% Tipping
- 8.33% Tipping to nil

**Real estate**
- 48.48% Tipping to nil
- 46.97% Fixed
Premium
The ‘rate on line’ is the one-off premium expressed as a percentage of the policy limit.

In our experience, pricing has varied significantly across jurisdictions. For German operational businesses, rates on line are usually 1.3-1.65%, whilst a similar target in Spain would usually incur a rate on line of 1.8-2.1%.

To our clients’ advantage, we generated insurer competition to secure lower rates on line in Q4 2015. This reversed the trend of the previous nine months and was most pronounced in the real estate sector where we regularly obtained rates on line of less than 1%.

Average rate on line

<table>
<thead>
<tr>
<th>Region</th>
<th>Operational business</th>
<th>Real estate</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>1.44%</td>
<td>1.22%</td>
</tr>
<tr>
<td>DACH region</td>
<td>1.56%</td>
<td>1.39%</td>
</tr>
<tr>
<td>Southern Europe</td>
<td>1.65%</td>
<td>1.58%</td>
</tr>
<tr>
<td>Central Eastern Europe</td>
<td>1.60%</td>
<td>1.52%</td>
</tr>
<tr>
<td>Nordics</td>
<td>1.55%</td>
<td>1.44%</td>
</tr>
<tr>
<td>Asia</td>
<td>2.57%</td>
<td>2.41%</td>
</tr>
<tr>
<td>USA</td>
<td>2.43%</td>
<td></td>
</tr>
</tbody>
</table>
Policy period

The policy periods match the survival periods in the underlying agreement, but a buyer-side policy offers the flexibility to extend such caps. The graphic below illustrates the different survival periods by classification of the warranty – general, fundamental (title and capacity) and tax.

Owing to insurers’ lower cost of capital, we regularly place policies with much longer survival periods than those which buyers have historically been able to obtain from sellers. Our statistics support this with 56.64% of our policies containing general warranty periods of 24 months or more.

General warranties

- 17.70% 18 - 24 months
- 25.66% 18 months
- 56.64% 24 months or more

Fundamental warranties

- 35.40% 7 years or more
- 11.50% 4 - 7 years
- 53.10% 4 years or less

Tax warranties

- 57.52% 7 years
- 20.35% 4 - 7 years
- 22.12% 4 years or less
**Tax indemnity**

For the purpose of a W&I Policy, the tax indemnity is typically qualified by matters fairly disclosed in the data room and the buyer’s due diligence reports. We have been at the forefront of improving this position for our clients, securing certainty of cover for key risks. On real estate deals these are regularly matters such as residency, trade tax, RETT and VAT.

The below graphic illustrates the percentage of DACH deals we placed last year in which the underlying deal contained a tax indemnity. If a tax indemnity was agreed between the parties, it was always insured. Importantly, if the seller is unwilling to offer a tax indemnity, we are able to structure a synthetic tax indemnity between the buyer and the insurer. When structuring a synthetic tax indemnity, we recommend the seller provides customary tax warranties in order to give insurers comfort that a thorough disclosure exercise is carried out.

**% of DACH deals with underlying tax indemnity**

**Operational business**

71% Yes

29% No

**Real estate**

71% Yes

29% No
**Jurisdictions**

Our global expertise supported transactions in 32 different countries last year.

Increased demand for the product in DACH saw the region establish itself as the “growth market” of Europe. Germany is however still significantly behind the UK and Nordics in terms of market penetration.
Last year M&A insurance became an increasingly common feature of DACH transactions. We also saw the “stapling” of insurance used more commonly on deals in the latter half of 2015.

With sellers looking to conclude sale processes quickly, we expect this trend of “front loading” of the insurance process to continue during 2016.

We have used increased insurer competition to our clients’ advantage by negotiating wider cover, lower premiums and lower deductibles. We secured these improved terms across operational and real estate deals, with the most notable changes obtained in the latter. We regularly achieved deductible levels of 0.1% of the deal value or lower on such deals and premium rates below 1% of the policy limit.

We received a greater number of claim notifications in 2015, the majority of which were notified within 12 months of completion. The broad policy wording enhancements we achieved resulted in a smooth claims process from notification through to payment. One such example was ensuring the policy definition of loss was sufficiently wide to include loss of profits.
The forecast

The increasingly aggressive approach of tax authorities has resulted in a heightened awareness amongst fund managers of the impact of tax liabilities on investments.

In 2016, we anticipate a greater demand for insurance to ring-fence such liabilities. We have recently hired a senior UK tax lawyer in order to further develop bespoke tax policies, including one that allows real estate fund managers to maximise return to investors at the end of the life of the fund.

We will continue driving product innovation in 2016, building on our improvements to the treatment of the tax covenant under the W&I policy by providing affirmative cover for key tax risks.

The greater use of the product has resulted in a more sophisticated M&A insurance market but one in which the scope of policy terms varies widely. Our aim is to ensure you obtain the best pricing and service from the market and, most importantly, a policy wording that you can truly rely on in the event of a claim.
The Howden Mergers & Acquisitions team provides specialist insurance solutions for M&A risks. The seventeen professionals that make up our dedicated team have backgrounds in corporate and tax law, investment banking, general industry and insurance.

With offices in the UK and Germany, we focus on the private equity and real estate sectors, working with leading fund managers across Europe and North America.

Our expertise covers the design of a range of bespoke policies and their successful placement to support M&A transactions. We advise on a variety of insurance products including warranty & indemnity, tax liability, contingent risk, environmental liability and title/real estate. Included in our placement fee (paid for by the insurer), we also provide a claim handling and advisory service to all of our clients. Our experienced team has a track record in obtaining M&A insurance claims pay-outs for our clients.