When selling a portfolio company, private equity sellers don’t like to give warranties as it limits distribution to investors. The bulk of the warranty burden falls to management who are best placed to give operational warranties given they are involved in the day to day operation of the business. Whilst private equity (PE) sellers will resist providing operational warranties, it is generally accepted they will give fundamental warranties (title to the shares and capacity to sell).

Management will typically cap operational warranties in the region of 10-30% of the purchase price. By contrast, fundamental warranties are normally capped at the consideration and this is supported by empirical data. According to a recent study, 90% of private M&A transactions in 2015 capped fundamental warranties at the purchase price or were expressly unlimited.1

PE funds typically acquire portfolio companies through special purpose vehicles (SPVs). These SPVs are designed to isolate financial risk – they generally only hold the shares of the portfolio company and have very few or no other assets. Buyers want comfort that, in the event of a breach of a warranty, the PE seller’s SPV will be able to meet its financial obligations. Historically, PE sellers have satisfied buyers concerns by placing a portion of sale proceeds in escrow or providing a ‘fund guarantee’. However, the cost of capital of a PE fund means that an escrow account or ‘fund guarantee’ is an unfavorable compromise – limiting returns to investors.

Record levels of capital have led to intense competition for assets, resulting in highly competitive auctions and a sellers’ market. This sellers’ market has allowed PE sellers to avoid both escrows and ‘fund guarantees’. Instead PE sellers are using Warranty and Indemnity (W&I) insurance to provide buyers with protection for a breach of warranty. Although the W&I policy will cover the fundamental warranties, cover will be capped at the policy limit. In 2015, W&I policy limits placed by Howden averaged 30.57% of the purchase price – leaving almost 70% of the purchase price uninsured.

Although the seller will normally give the fundamental warranties to protect the buyer above the W&I policy limit, buyers are often uncomfortable with the seller’s covenant strength. In a sellers’ market, buyers are generally unable to obtain a fund guarantee – leaving the buyer with the choice of ‘taking a view’ or purchasing more insurance. It is possible to obtain additional cover from the W&I insurance market, but this can cost 50bps of the additional cover. On a £100m deal, an additional £70m of cover for the fundamental warranties would cost £350k – a considerable cost.

In response to the pitfalls identified above, Howden has developed a solution with legal indemnity insurers - protecting buyers against a breach of the fundamental warranties in excess of the W&I policy. The legal indemnity policy provides cover for share ownership across the full target group and, if the group holds property, general ownership cover for the property. These policies are typically priced at 10bps to 20 bps of the policy limit – the same additional £70m of cover is therefore priced at £70-140k. The cover provided by a legal indemnity insurer differs to a W&I policy - it is therefore important the bespoke wording is correctly drafted to ensure there are no ‘gaps’ in cover and, in particular, it aligns with the underlying W&I policy.

With W&I insurance now a firm feature of the deal landscape and there being no signs of this sellers’ market abating, the use of legal indemnity insurance to provide a cost effective solution to the fundamental warranty gap looks set for continued growth.

1 2016 SRS Acquiom M&A Deal Terms Study
Thank you for reading.

Interested in learning more about Howden’s Mergers and Acquisitions team?

Check out our new website

Richard French & David Haigh

Richard

Richard is a founder and Director in Howden’s M&A team. Richard has a BSc in Economics from the University of Bristol.

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David is an Associate in Howden’s M&A team. Whilst at Howden, David has grown our US book, working on transactions ranging from $50m - $3.5bn. David holds a Master’s Degree in Chemistry from the University of Durham.

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