

Mergers & Acquisitions Global Review and Outlook

APRIL 2020



Gallagher

Insurance | Risk Management | Consulting

ABOUT GALLAGHER

Founded by Arthur Gallagher in Chicago in 1927, Gallagher (NYSE: AJG) has grown to become one of the largest insurance brokerage, risk management, and human capital consultant companies in the world. With significant reach internationally, the group employs over 33,000 people and its global network provides services in more than 150 countries.

Gallagher's London divisions offer specialist insurance and risk management services. We provide bespoke policy wordings, programme design and risk placement solutions, and consulting support across a range of specialisms. We manage complex, large, global risks on a direct and wholesale basis and serve as primary access point to Lloyd's of London, London company markets, and international insurance markets.

WE HELP BUSINESSES GO BEYOND THEIR GOALS.

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OBSERVATIONS FROM 2019

2019 proved to be the fifth record year in a row for the M&A insurance market. More M&A insurance products such as Warranty and Indemnity (W&I) or Representations and Warranties (R&W) insurance were used in 2019 than any other year. Tax and Contingent Risk insurance has also become a staple part of the M&A insurance repertoire. Whilst private equity funds are traditionally the driving force behind the use of M&A insurance (as a way to reduce balance sheet exposures), this has spurred on other private investors and corporates to take the same approach. Institutional sellers no longer see any need to offer escrow arrangements to prospective buyers since the insurance replaces this need and allows for a clean exit.



Competition

The growing need for M&A insurance products (including W&I, R&W, Tax and Contingent Liability insurance) has attracted more insurers to enter the fray, which inevitably creates competition and sparks innovation.

With over 25 UK based insurers and over 40 markets worldwide, underwriters have expanded into territories that were previously uninsurable. Jurisdictions such as Latin America, Africa and the Middle East are now within insurers' appetite and cross-border legal constraints are no longer an issue. In short, very few jurisdictions are uninsurable.

Some underwriters have reduced their minimum premiums to as low as GBP40k (USD90k in the US) to attract new business within the Small and Medium Enterprise (SME) marketplace. Deal sizes lower than GBP15m, that were perhaps not commercially sensible to insure due to minimum premiums of GBP100k (or USD200k) are now much more palatable, especially if the premium can be shared between the buyer and the seller.

Capacity

Whilst the maximum limit any one insurer can put down is now USD200m, the level of global capacity for any one deal has risen to over USD2bn, with an increasing desire to underwrite the primary layer. Although some insurers prefer to follow certain markets, the general underwriting experience across all markets is strong, allowing for large limits to be purchased.

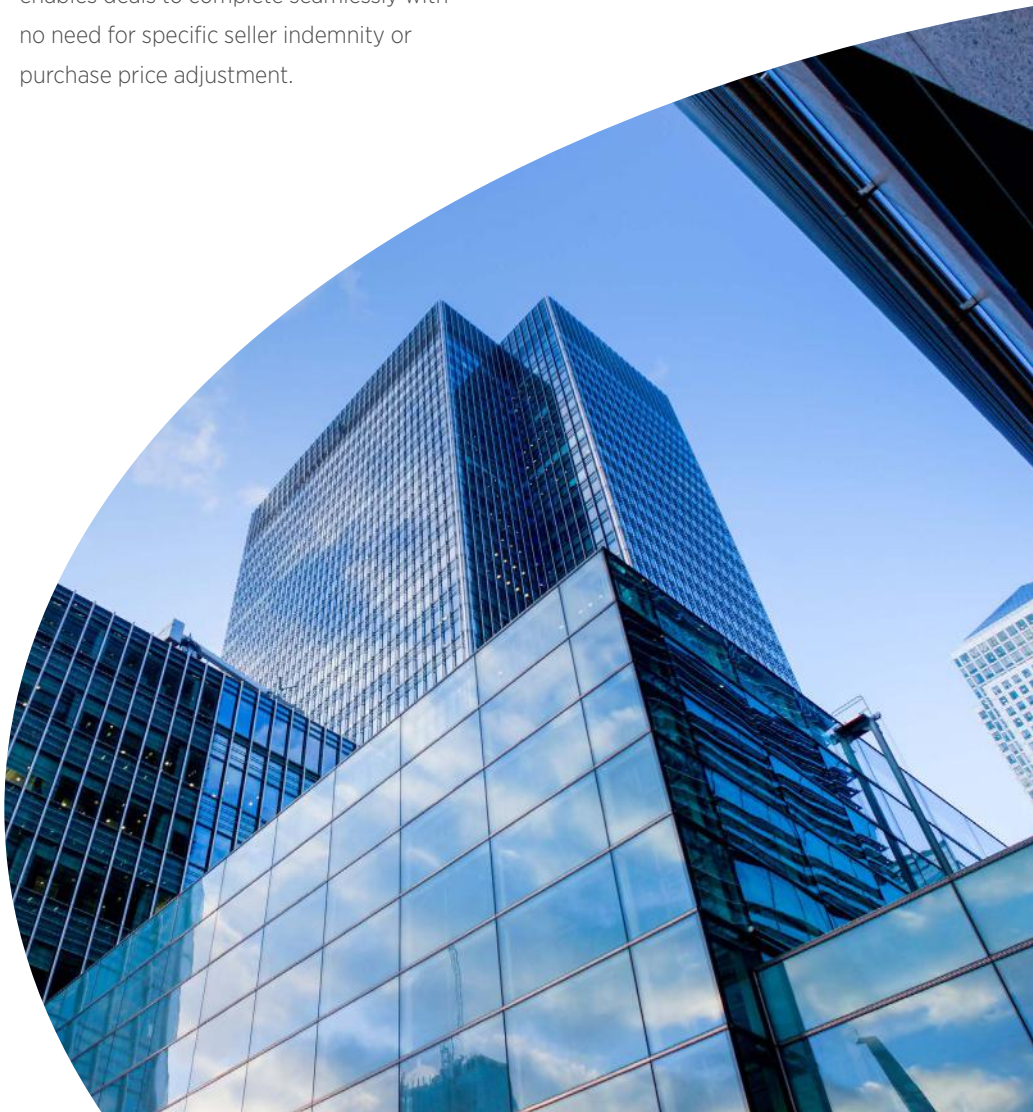
Innovation

Innovations in coverage were a big feature of 2019. Knowledge and materiality scrapes, synthetic tax covenants and cover for pre-completion re-organisations are becoming standard on both sides of the Atlantic. Australian insurers are going further and offering new breach cover on most transactions. Some insurers are slower than others in terms of what can be offered but, generally speaking, markets are becoming more commercial when it comes to policy drafting.

One of the biggest changes in the W&I landscape over the last twelve months has been the introduction and growth of tax insurance. Due to increased 'in-house' tax experience, it is now common-place for known tax issues flagged in Due Diligence (DD) reports to be wrapped into W&I coverage, if quantified and opined on. This enables deals to complete seamlessly with no need for specific seller indemnity or purchase price adjustment.

Claims

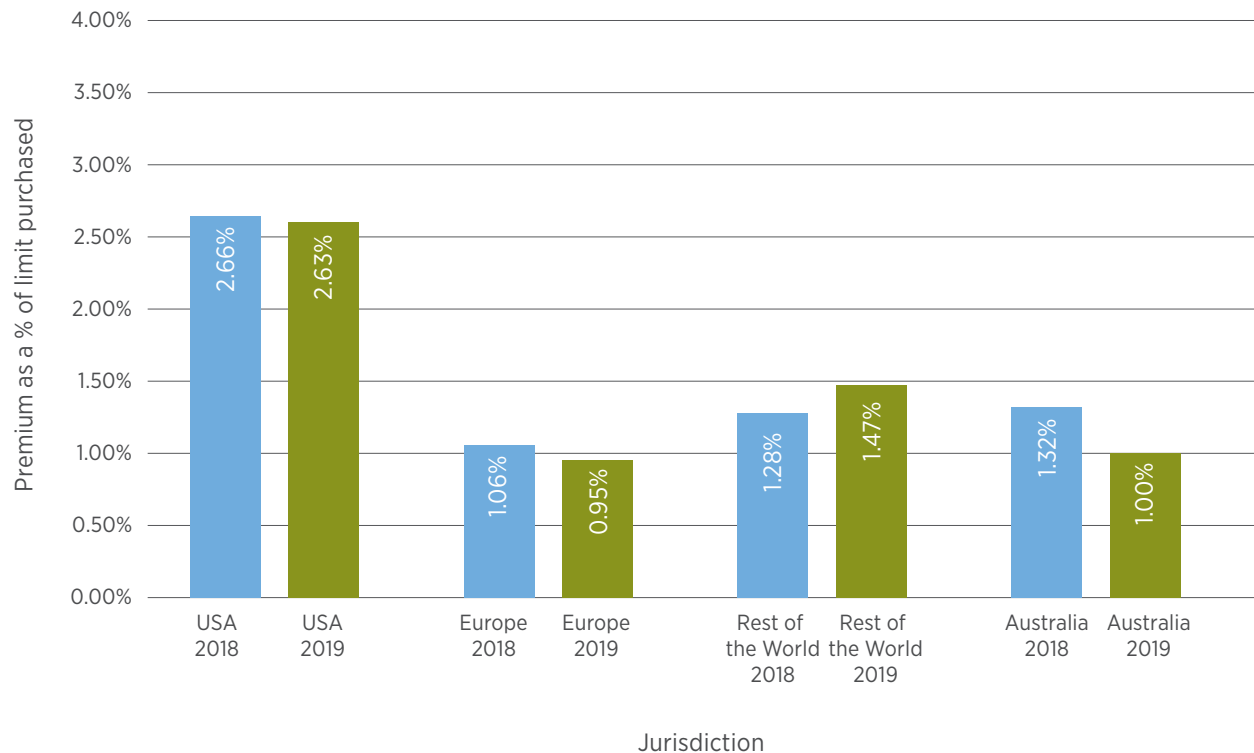
Claims notifications have increased significantly over the last twelve months as the claims process continues to sophisticate. This is driven by a greater volume of M&A policies being placed as well as insurers providing broader coverage, insuring larger deals and accessing more jurisdictions. Furthermore, in the months following completion, buyers have started to dig deeper into analysing whether warranties given by the seller actually underpinned certain valuations prior to closing. In particular, insureds are increasingly relying on M&A insurance where financial statements have proven inaccurate.



2019 Gallagher M&A Global Trends

These statistics are based on rates that Gallagher's M&A team has obtained from the global M&A insurance market over 2018 and 2019.

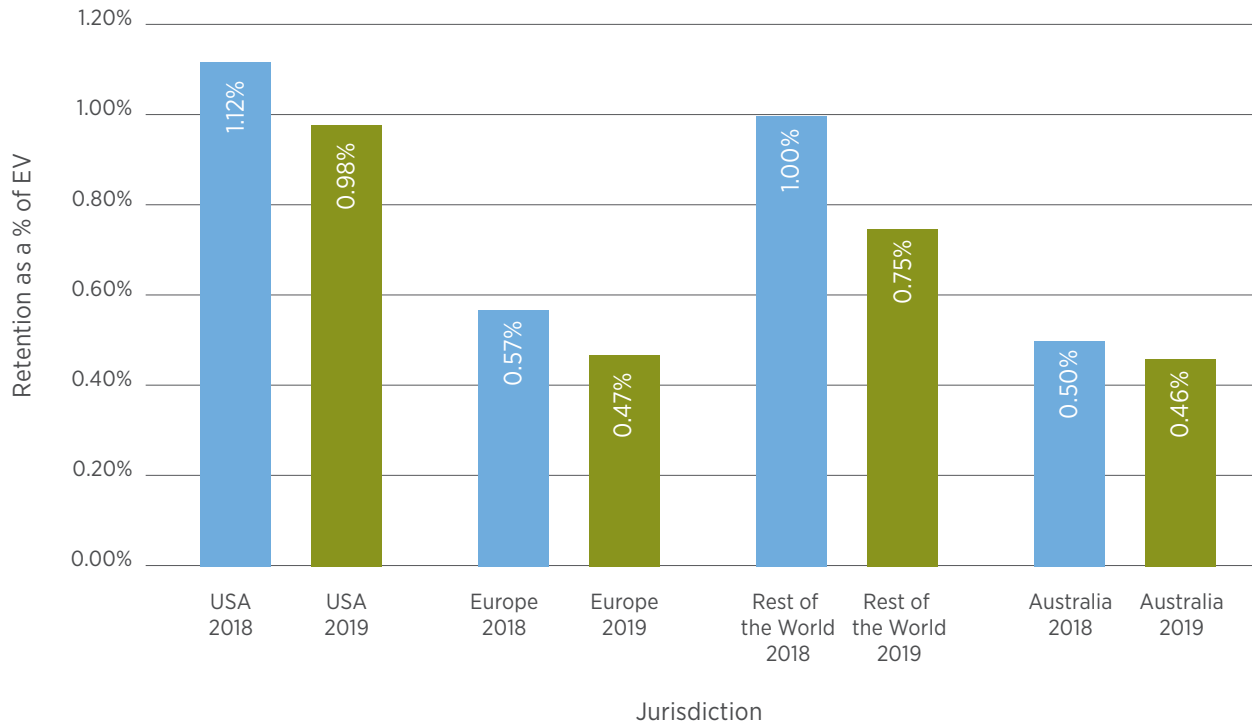
Average Global Premium Rates 2018 vs 2019



Although the number of insurers in North America and Europe has nearly doubled over the last two years, the reduction in premium rate has not been as dramatic. Rather than trying to compete on price, insurers are broadening coverage in order to win deals (such as wrapping in 'low risk' tax items that are identified in DD reports). Australian rates have reduced more significantly as UK insurers compete with the already established Australian market. Whilst it might seem odd that the 'rest of the world' premium rates have increased, this is due to insurers expanding into unknown jurisdictions and covering deals that were previously uninsurable (albeit at a higher rate). As insurers become more comfortable in emerging markets, we expect these rates to drop in the coming years.

Please note that minimum premium levels in many territories push the average premium rate up slightly. In the US and Australia, limits under USD 4m and AUD 7m, respectively, are likely to push the rate up significantly as we venture into minimum premium territory. Similarly in Europe, anything under GBP 4m would push the rate higher than the 2019 average of 0.95%.

Average Initial* Global Retention Rates 2018 vs 2019 (not including pure real estate deals)



*The retention is an industry term for the policy's excess. The retention is the aggregate sum of loss which is borne by a person other than the insurer. In the examples below, the retention applies to the aggregate losses covered by the policy.

Fixed Retentions: The insurer is only liable for losses that exceed the retention.

Partially Tipping Retentions: Once losses exceed the retention, it tips down to a lower level and the insurer is liable for losses exceeding that lower level.

Fully Tipping Retentions: Once losses exceed the retention the insurer is liable from the ground up.

Dropping Retentions: After a certain time period, the retention will drop to a lower level.

Nil Retentions: The insurer is liable for all loss covered by the policy, subject to a de-minimis.

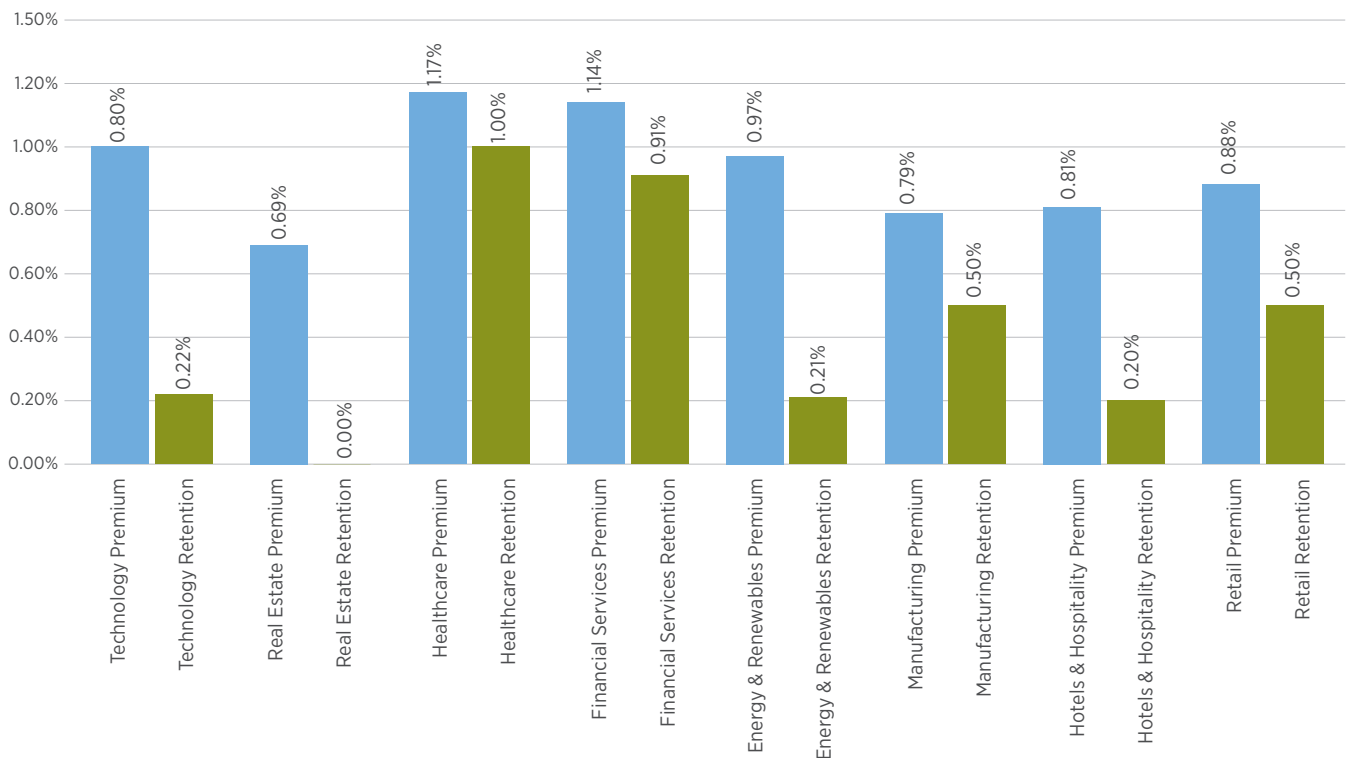
Insurers are becoming more innovative when it comes to retention structures; fixed, tipping and even nil retentions are available in Europe and Australia while dropping retentions are now the norm on most US corporate deals.

For some larger transactions, US insurers are offering retentions as low as 0.75% dropping to 0.5% of deal value (although an initial rate of 1% is standard) and even lower for real estate acquisitions.

As a standard rule, European and Australian 'clean real estate transactions' attract a nil retention and operational businesses see retentions between 0.3% and 1% of deal value (Financial Institutions deals are at the higher end).

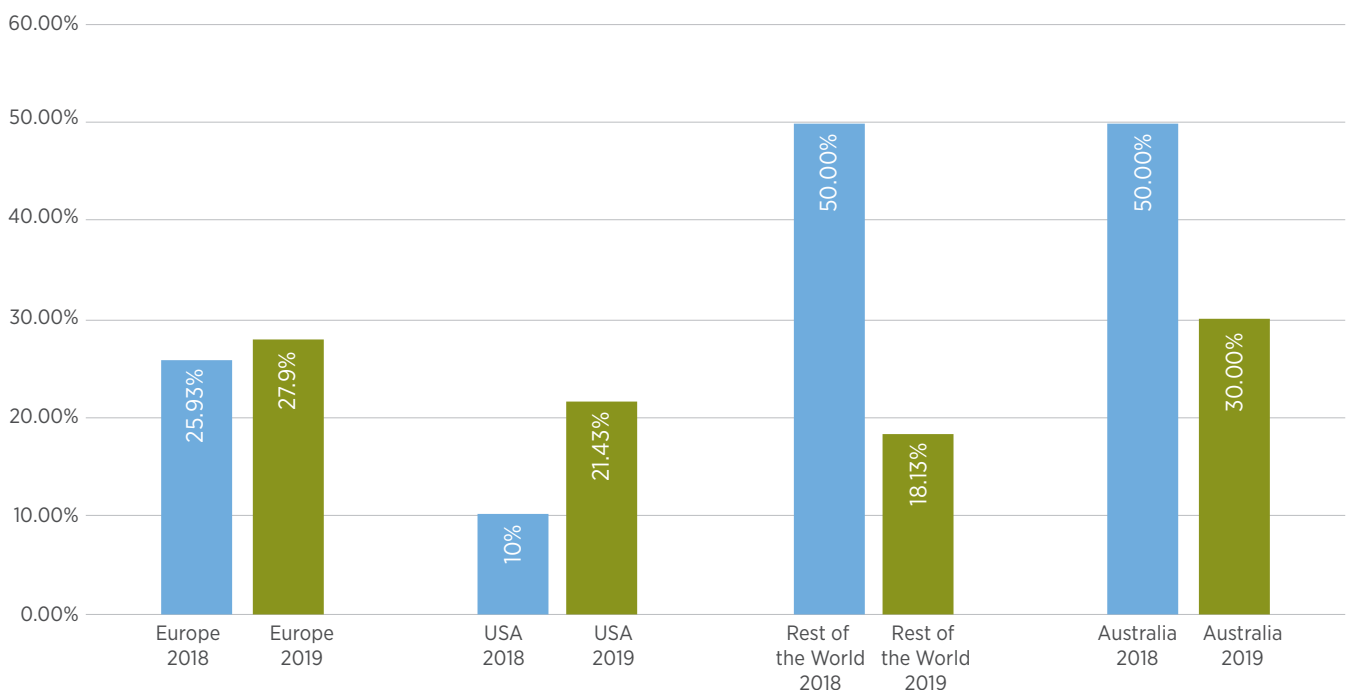
Retention levels for the rest of the world vary significantly, depending on the jurisdiction. A 1% fixed retention is the starting point however we see this figure increase depending on deal size and whether certain aspects are covered such as employee and tax warranties.

Average Premium and Retention Rate by sector in 2019 – Europe



The graph shows that lowest premium and excess rates are attributable to the real estate sector, since there is little or no operating business risk. The more risky sectors tend to involve more heavily regulated industries such as financial institutions and healthcare.

Average Limit Purchased as a % of EV – 2018 vs 2019



Whilst the 2018 statistics show a wide diversity of limits bought (as a % of enterprise value), the general global trend in 2019 demonstrated that between 15%-30% was purchased. The overall drop in premium rates has inspired some buyers (particularly in the USA) to purchase more (as they can get more insurance for the same premium a year previously). That said, the reduction in minimum premiums has allowed clients to buy less in some instances (where deal values are perhaps lower than GBP30m and cutting costs are critical).

2020 OUTLOOK

In the short term, we expect a downward tick in M&A transactions due to the economic repercussions of Covid-19. Buyers, sellers, lenders and financial sponsors will be paying close attention to the impact that the virus has on a target's financial performance, which is likely to paint an uncertain if not negative picture

going forward. For now, many are taking a wait and see approach.

Later in the year, we expect the frequency of M&A transactions to recover. As time moves on, pressure will mount on funds which need to deploy capital (some funds will have been sitting on reserves months before the Covid-19 crisis due

to other localised political and financial circumstances). Pressure will also mount on struggling businesses to restructure and divest. We also expect to see an increased number of opportunistic acquisitions. Whether for distressed or profitable businesses, M&A insurance will continue to play a vital role.

M&A INSURANCE MARKET OUTLOOK

Claims

In the near future, we anticipate an increase in the rate of claims against W&I policies placed before and after the Covid-19 crisis. Recently acquired businesses that suffer over this period will look to all available insurances, including their W&I. For example, warranties that talk to material contracts will be closely examined post close, especially if the target's financial performance were to drop significantly.

Looking further ahead, the rate of claim notifications will continue to increase. This is due, in part, to the Covid-19 crisis, but principally the volume and range of deals that have been and will continue to be insured.

Underwriting

The knock on effect is already being felt during underwriting, as insurers are increasingly demanding various Covid-19 related exclusions and restricting cover for warranties that could be sensitive to Covid-19 impact. The underwriting process is also expected to become more thorough and defensive for hard hit sectors, such as hospitality and retail. In nearly all cases, insurers will expect to see a thorough review on how Covid-19 might affect the target business and will ask detailed questions on matters such

as commercial negotiations, the accounts date, material contracts, insurances and employment issues.

Similarly, if distressed business acquisitions or public to private deals become a recurring theme, we expect to see increased pressure on buy-side due diligence. Insurers will need to see in-depth diligence in all areas, especially if they are to consider synthetic warranty packages.

W&I Market Expertise

In the long term we expect continued investment and recruitment in the W&I market as insurers expand into different territories across the globe. Similarly, whilst traditionally hiring corporate lawyers, insurers are recruiting an increasing number of specialists from different professions and industry sectors in an attempt to deliver broader coverage and a slicker process. As more W&I and tax insurance policies are negotiated and placed, what might have traditionally taken a number of weeks or months, might take a number of days by the end of 2020.

Pricing, Capacity and Innovation

Pricing in 2020 is likely to remain the same. In the near term, although the risk profile of some businesses may have increased due to Covid-19, insurers will be competing to win a smaller pool of deals.

In the long term, whilst we expect to see continued competition in the M&A insurance market, we don't expect to see a continued decrease in W&I premium rates, mainly due to the growing number of claims paid out by insurers.

Total market capacity is also likely to remain the same. So long as other insurance lines are not hit hard by Covid-19, the M&A markets are still likely to be supported in the medium term. Insurers may however be more careful about deploying their maximum line on any one risk. For larger deal sizes in Europe we might also see a decrease in the average primary W&I limit as insurers attempt to decrease their exposure by ventilating capacity further up the tower.

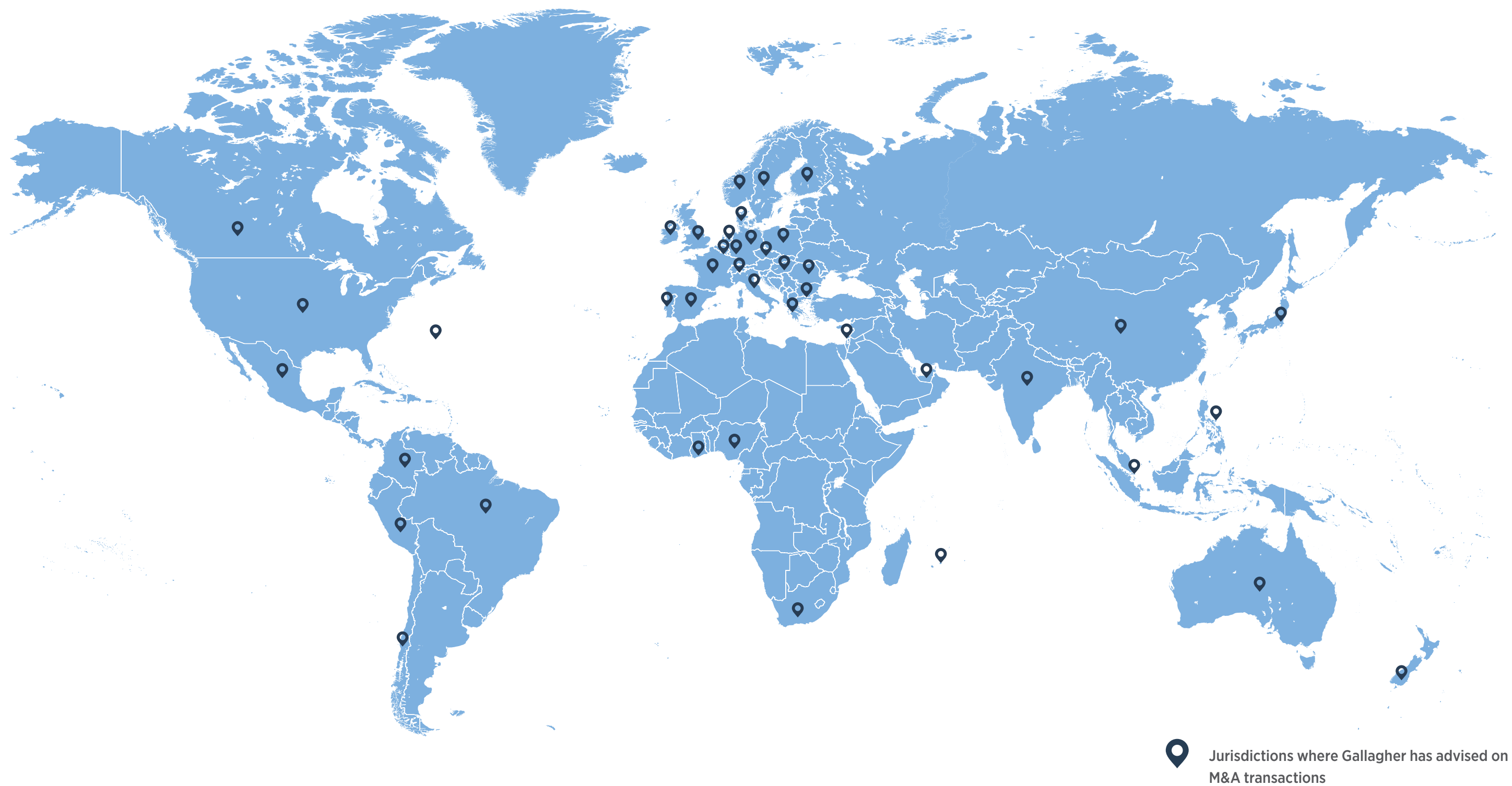
With the stabilization of W&I pricing, we expect insurers to increase efforts to differentiate themselves through W&I policy innovation (such as affirmative tax cover), and offering standalone known risk cover (such as tax, litigation, and environmental liability insurance).

W&I, tax and contingent risk products are becoming firmly entrenched within the typical deal structure, with clients and lawyers coming to us with traditional and novel issues. We still expect to see a continued rise in the percentage of M&A transactions that utilise these policies in both the short and long term.

M&A: GLOBAL REACH

The Gallagher M&A insurance team has advised on over \$10bn of combined deal value in 2019.

Whilst the market continues to mature in Europe, Australasia and North America, Gallagher has also started to structure deals involving pure South American or African operations.



M&A CONTACTS

Whilst 2019 saw a continued rise in W&I and tax insurance, it was a ground-breaking year for the Gallagher M&A insurance team, having advised on over \$10bn combined deal value in 2019.

By tripling its headcount in London as well as expanding into Australia and the US, the team has bolstered its global offering and significantly strengthened in the transactional risk space. The recruitment of some of the most effective M&A brokers, corporate solicitors, tax specialists and ex-M&A underwriters, allows Gallagher M&A to facilitate and structure some of the most complex multi-jurisdictional deals.

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CONCLUSION

2019 has been another record year for M&A insurance. W&I, R&W and tax policies are now used or considered on a majority of deals across the globe since they alleviate difficult negotiations and ultimately allow for a smoother sale process. The success and innovation of these products has led to increased insurance capacity and a steady influx of underwriters with a broad range of professional backgrounds.

2020 has quickly become a challenging time within the entire M&A sector. The short term impact of Covid-19 will mean a decrease in deal flow but ultimately it could lead to opportunity later in the year, especially for cash rich buyers. Underwriters will be spending more time on Covid-19 sensitive warranties and will expect greater due diligence in these areas too.

In spite of the doom and gloom, insurers will continue to differentiate traditional W&I coverage by offering enhanced and nuanced coverage where they can, including synthetic W&I insurance cover. We also expect to see an exponential rise in the number of known risk and contingent insurance policies being used and dovetailed into the traditional W&I structure.

From the simple transactions to the most complex cross-border deals, the Gallagher M&A team can help facilitate negotiation and structure policies to allow for a smoother process.





DISCLAIMER

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