Global Mergers & Acquisitions Outlook Report

JANUARY 2021

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.

Contents

Executive Summary 04

Average Global Premium Rates as a % of Insured Limits – 2020 06

Average Initial Global Retention Rates as a % of Enterprise Value (EV) – 2020 07

Focus on European Sectors: Average W&I Premium & Retention Rates 08

Focus on European Jurisdictions: Average W&I Premium & Retention Rates 09

Average Global Limit Purchased as a % of EV – 2020 10

2020 Gallagher M&A Claims Statistics 11

Tax & Contingent Liability 12

2021 M&A Insurance Outlook 13

Outlook Recap 14

M&A Insights 16

Why Gallagher? 18

Key Contacts 20

Executive Summary

It should come as no surprise that 2020 has proved to be a tough year for both Mergers and Acquisitions (M&A) insurance and M&A transactions as a whole. As soon as the first lockdown was announced in March, almost all M&A activity ground to a halt leading to the slowest second quarter in decades (in terms of completed deals).

However, during the summer months, the M&A industry started to recalibrate and many transactions (that were initially halted) began to close. Activity picked up in robust sectors that were immune to (or even favoured) the pandemic, such as technology and renewables, and opportunities arose in healthcare, pharmaceuticals and FinTech. Whilst private equity activity has remained at a low level for most of the year, as time has been spent supporting portfolio companies, the last quarter has seen private equity deals gathering pace, with increased auction sales. Although there has not been as much distressed M&A activity as expected earlier in the pandemic, this is likely to rise in early 2021.

Overall, whilst different jurisdictions will rebound at different times, there are cautious signs of optimism as the M&A global market shows signs of significant recovery.

From an insurance perspective, 2019 saw one of the highest increases in M&A insurance capacity; almost every market invested heavily in expanding their teams and new managing general agents (MGAs) were formed, adding further competition to the market. However, when the pandemic hit in early 2020, insurers were left with the potential issue of being over staffed and they needed to differentiate themselves quickly in order to win from a smaller pool of deals. Whilst these differentiators, such as the ability to cover known tax risks, were becoming more widespread by the end of 2019, many insurers used the slowdown in deal activity to reflect, reassess and find innovative ways of broadening their offerings. It became a common theme for insurers to opt for enhanced coverage rather than simply reducing premium, especially as rates were already considered to be lower than ever.

Coverage for known risks, such as quantified tax and contingent liabilities, has increased and insurers have also started to integrate environmental and title cover, allowing deals to complete much more smoothly.

From the outset of the pandemic, M&A insurers were less certain on how to approach COVID-19 exposures. We started seeing broadly drafted COVID-19 exclusions cutting across cover, but insurers are now taking a more nuanced approach by removing or excluding specific warranties. This has helped deal teams navigate COVID-19 exposures, with underwriters now asking relevant questions during underwriting. These processes not only allow some insurers to remove COVID-19 related exclusions, but also give buyers an opportunity to obtain a more comprehensive understanding of the effects that the pandemic has had on the target business.

Coverage for distressed M&A and public to private (P2P) transactions was a common theme in 2020 and we are likely to see more of this in 2021. The role of synthetic warranty insurance could become crucial for deals where the seller is not present or able to offer warranties, such as during a liquidation. Whilst these policies are more expensive than traditional Warranty and Indemnity (W&I) and Representations and Warranties (R&W) cover, the benefits cannot be ignored by investors, creditors and insolvency practitioners.

Insurers need to demonstrate their willingness to be commercial during the claims process. This year has seen a record year for W&I and R&W notifications, possibly due to the lull in deal activity (as recent buyers have used the time to forensically analyse what they have purchased), and reduction in capacity is becoming a common theme. At Gallagher we are proud to say that 2020 has been our record year in terms of M&A claims paid out via our placements.

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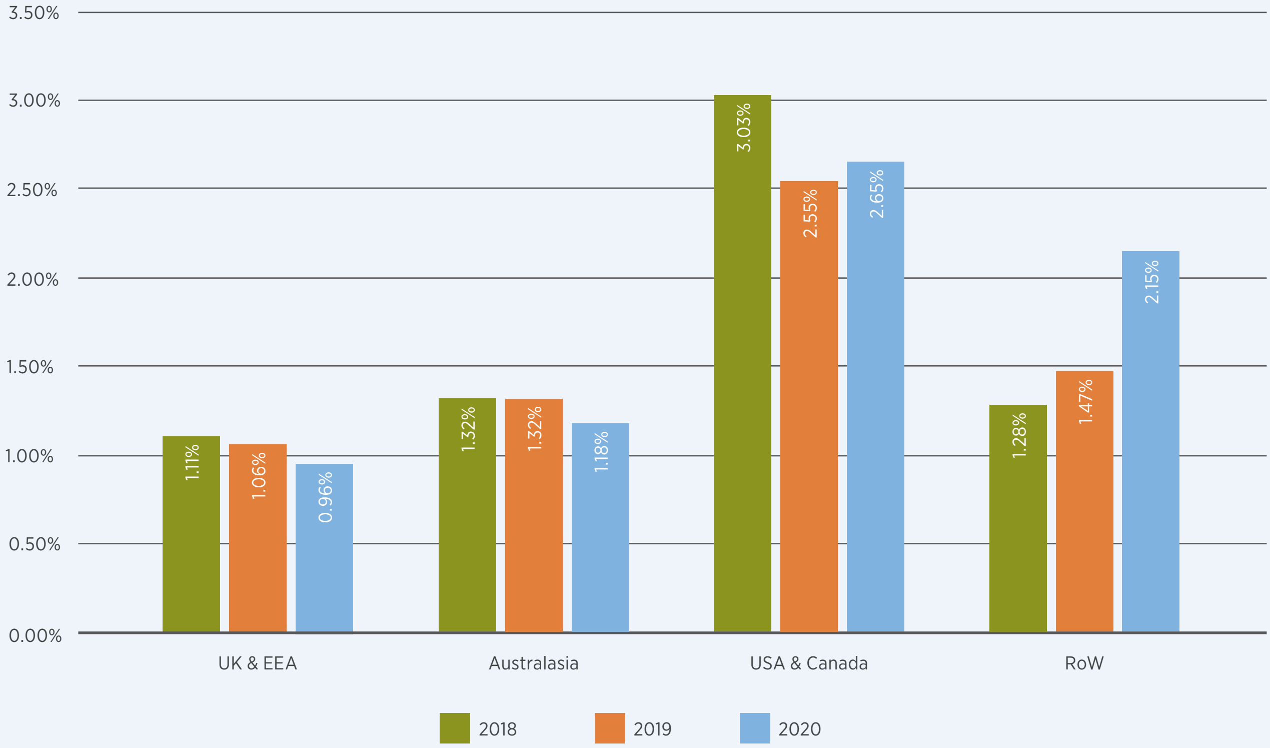
Average Global Premium Rates as a % of Insured Limits – 2020

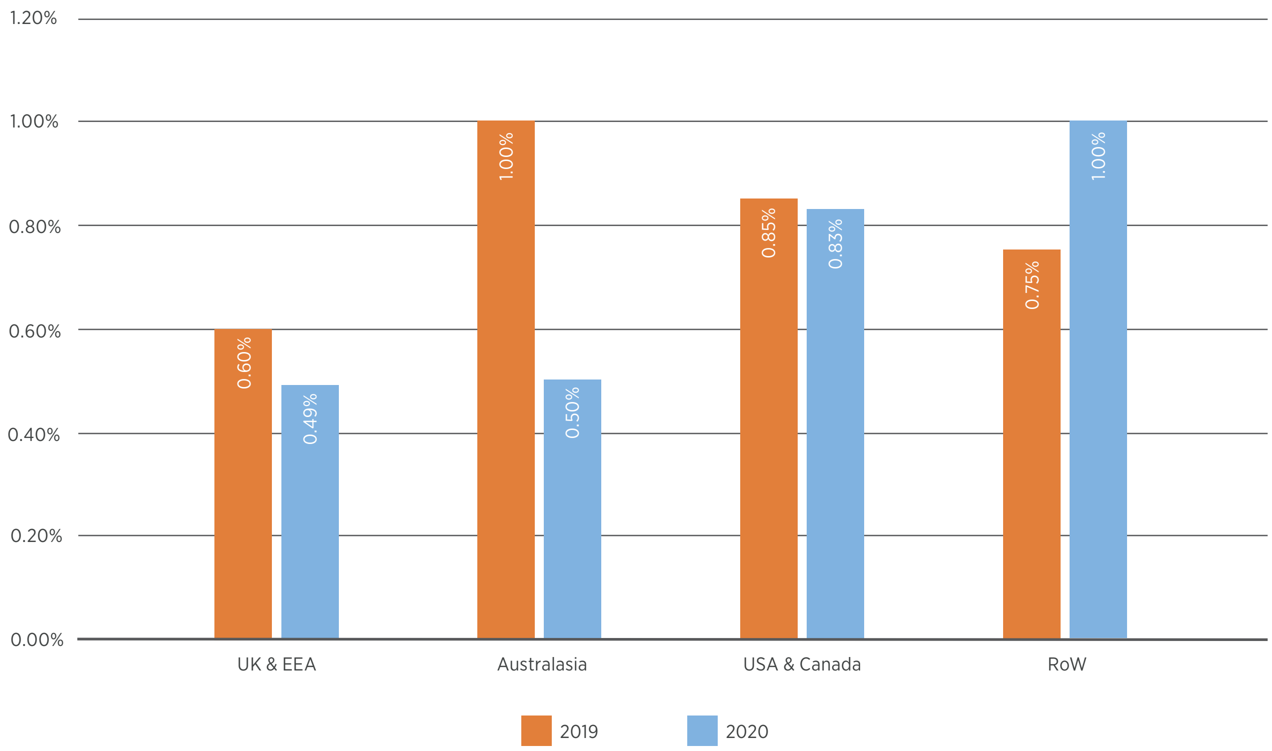


Whilst premium rates have dropped slightly in Europe and Australasia, rates in the US and Canada have started to increase. This may be due to an earlier M&A bounce back in the US, giving US insurers more scope to 'pick and choose' the deals they want to underwrite owing to less competition across a larger pool of deals. Note that Canadian deals have been included within the US category as often US-style policies are required to sit behind Canadian law Sale and Purchase Agreements (SPAs) – if European style policies, are selected these will attract a lower rate.

The market might also be starting to harden in the US, with Europe following this year, due to a combination of increasing M&A activity and a growing frequency of claim pay-outs. Across the rest of the world, the average rate has increased but, as with last year, this is mostly down to insurers creeping into unfamiliar territories (such as Africa and South America) rather than the rate in a specific jurisdiction steadily going up.

The Gallagher M&A team explores the entire M&A market for each and every deal, seeking the widest competition which can ultimately lead to the lowest rates available.

Average Initial* Global Retention Rates as a % of Enterprise Value (EV) – 2020



*The retention is an industry term for the policy's excess. The retention is the aggregate sum of loss which is borne by a party 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.

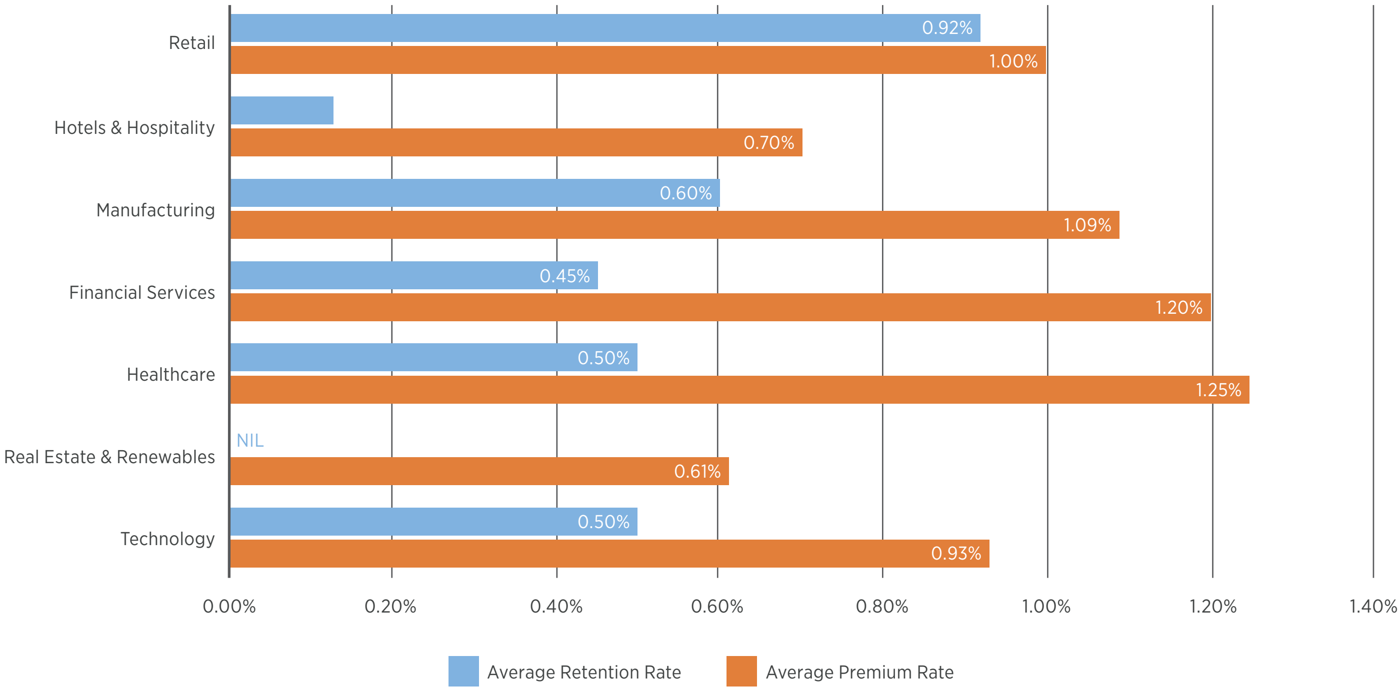
Dropping Retentions: After a certain time period, the retention will drop to a lower level.

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

Retention rates in Europe and Australasia have dropped in 2020, whilst the continued flexibility in offering different retention structures remains comparable with 2019. Australasia has seen a particularly marked drop in retention rates, perhaps since European based insurers have started underwriting Australian and New Zealand law deals, increasing competition. Nil retentions for real estate have crept into renewables and some hospitality deals while operating transactions remain at 0.25% - 0.75% of enterprise value (EV) (fixed or tipping). On small European deals, the de-minimis rate can be as low as EUR5,000.

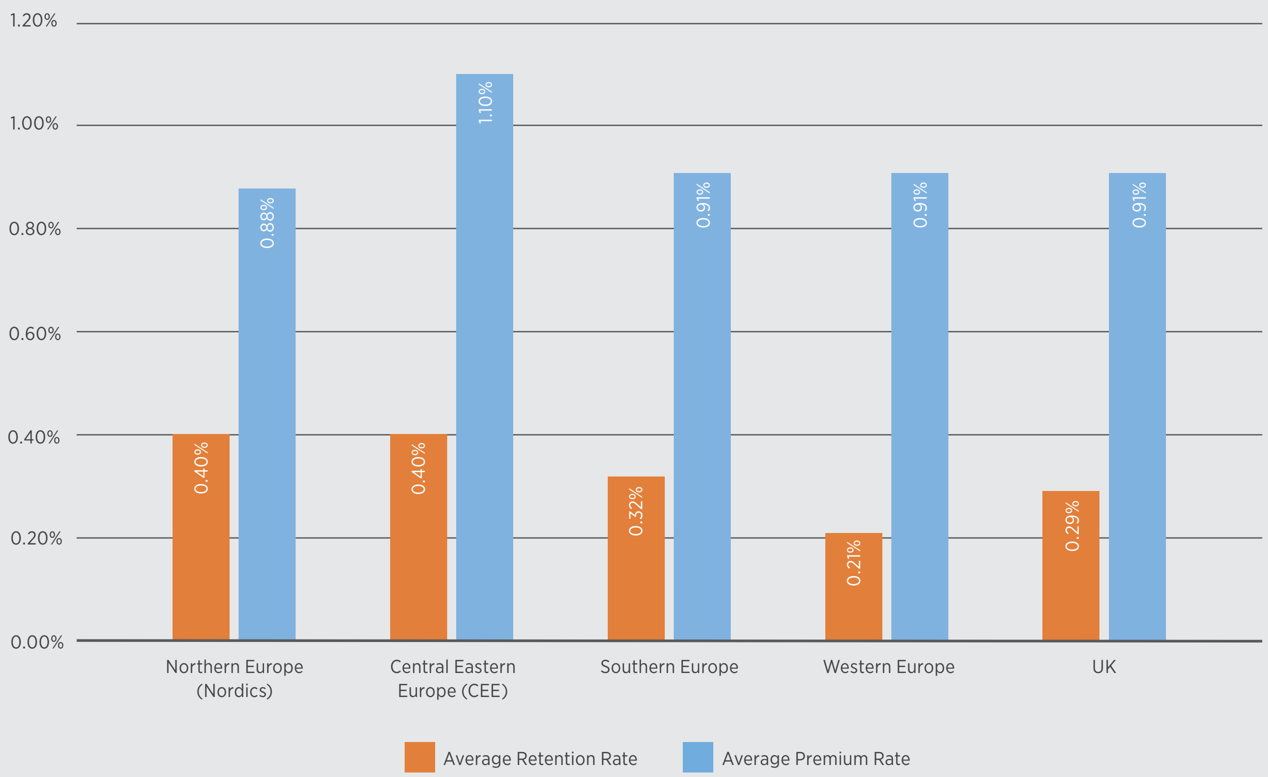
The US has also remained fairly consistent with last year; for most deals the standard level is 1% of EV (dropping to 0.5%), and this can reduce to 0.75% dropping to 0.5% for larger deals. Retentions across the rest of the world can vary but it will be unusual for this to be less than 1% of EV fixed. Nil seller liability has now become a global phenomenon as insurers can now accept the concept in most territories (it was previously unavailable in some territories as insurers needed sellers' 'skin in the game'). Please note that de-minimis rates continue to be quite high for tax items in the rest of the world and is still tracking materiality in due diligence (DD).

Focus on European Sectors: Average W&I Premium & Retention Rates



Whilst insurers have gained a lot of experience in the technology and pharmaceuticals sectors this year, real estate and renewables still attract the lowest premium rates and retentions, given the lack of operational risk. Interestingly, rates for the hospitality and retail sector have remained low despite the devastating impact of the pandemic. A slight drop in financial services rates can be attributed to growing underwriter appetite for these deals, with accountants and financial services specialists joining M&A teams across the market.

Focus on European Jurisdictions: Average W&I Premium & Retention Rates



At Gallagher, we have seen a dramatic increase in the use of W&I insurance across the whole of Europe. Whilst it has been traditionally more difficult to obtain W&I and tax coverage in Southern and Eastern Europe, these territories are now well within M&A insurers' remit. In fact, premium rates in Southern Europe (such as Italy and Spain) are now in line with those in Western Europe and the Nordics. As you will see, rates are a little higher in Eastern Europe but these are expected to drop in line with the rest of Europe within the next six months. Poland, for example, is one of the fastest growing territories when it comes to the use of M&A products and this uptake is likely to diffuse into the rest of Eastern Europe.

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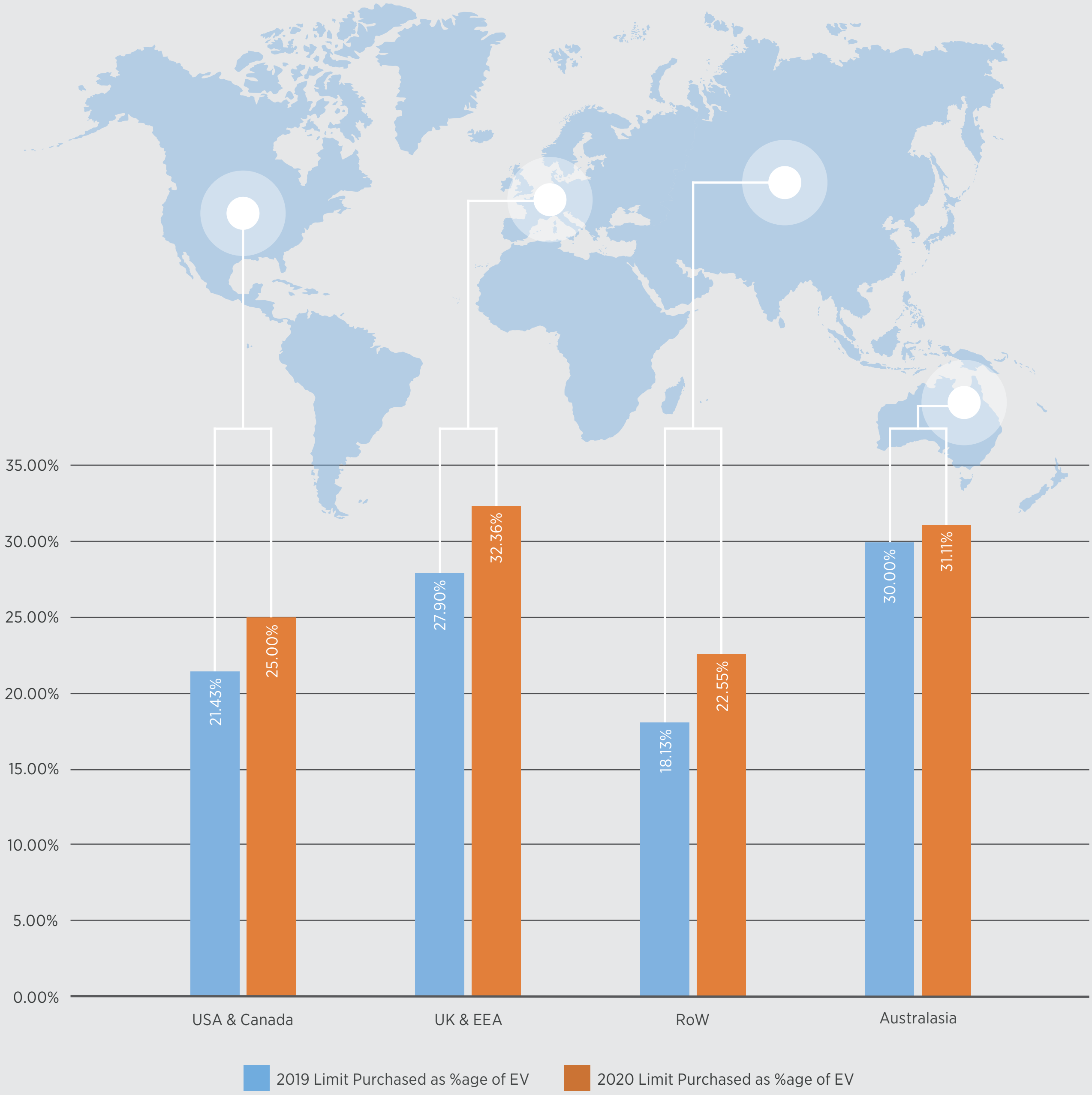
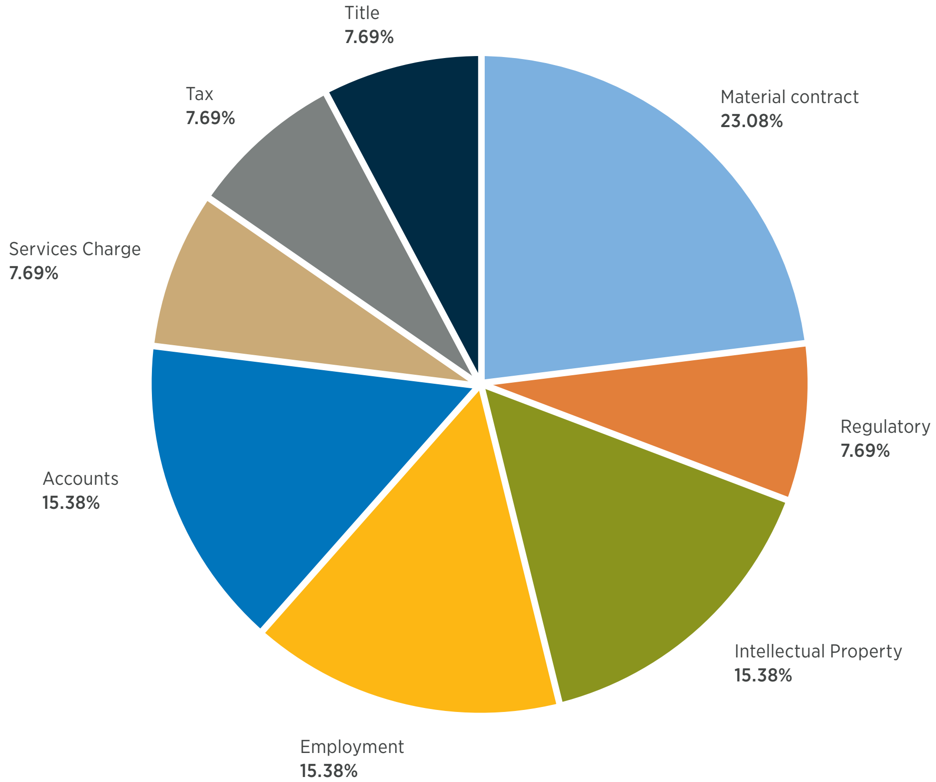
Average Global Limit Purchased as a % of EV – 2020



Since the pandemic begun, we have seen an increase in limits purchased as a % of EV compared with 2019. Gallagher has seen instances of clients notifying claims that are actually higher than the limits of insurance they have in place, which has led to a greater understanding of W&I risk and limit selection. As premium rates remained steady in M&A insurance (unlike other lines of insurance which have mostly increased), Gallagher clients are starting to buy more cover, especially as they can see that claims are being consistently paid out.

Due to significant premium reductions, over 35% of clients purchasing W&I insurance also opted for a standalone title policy or top-up cover for fundamental warranties (up to the full enterprise value).

2020 Gallagher M&A Claims Statistics



As you will see, the breadth of notifications is far reaching and includes almost every area that is warranted. Consistent with what we are seeing in the rest of the market, accounts warranties make up a significant number of warranty breaches, but breach of material contract warranties represent the highest percentage of Gallagher notifications in 2020, perhaps due to the pandemic.

It must be noted that employee litigation warranties are beginning to be breached regularly and, at Gallagher, this area represents the highest percentage of paid claims.

Seeing as over 20% of policies are notified against, there is now increasing pressure on insurers to provide a seamless claims service and pay valid claims quickly, so they are considered for the next deal.

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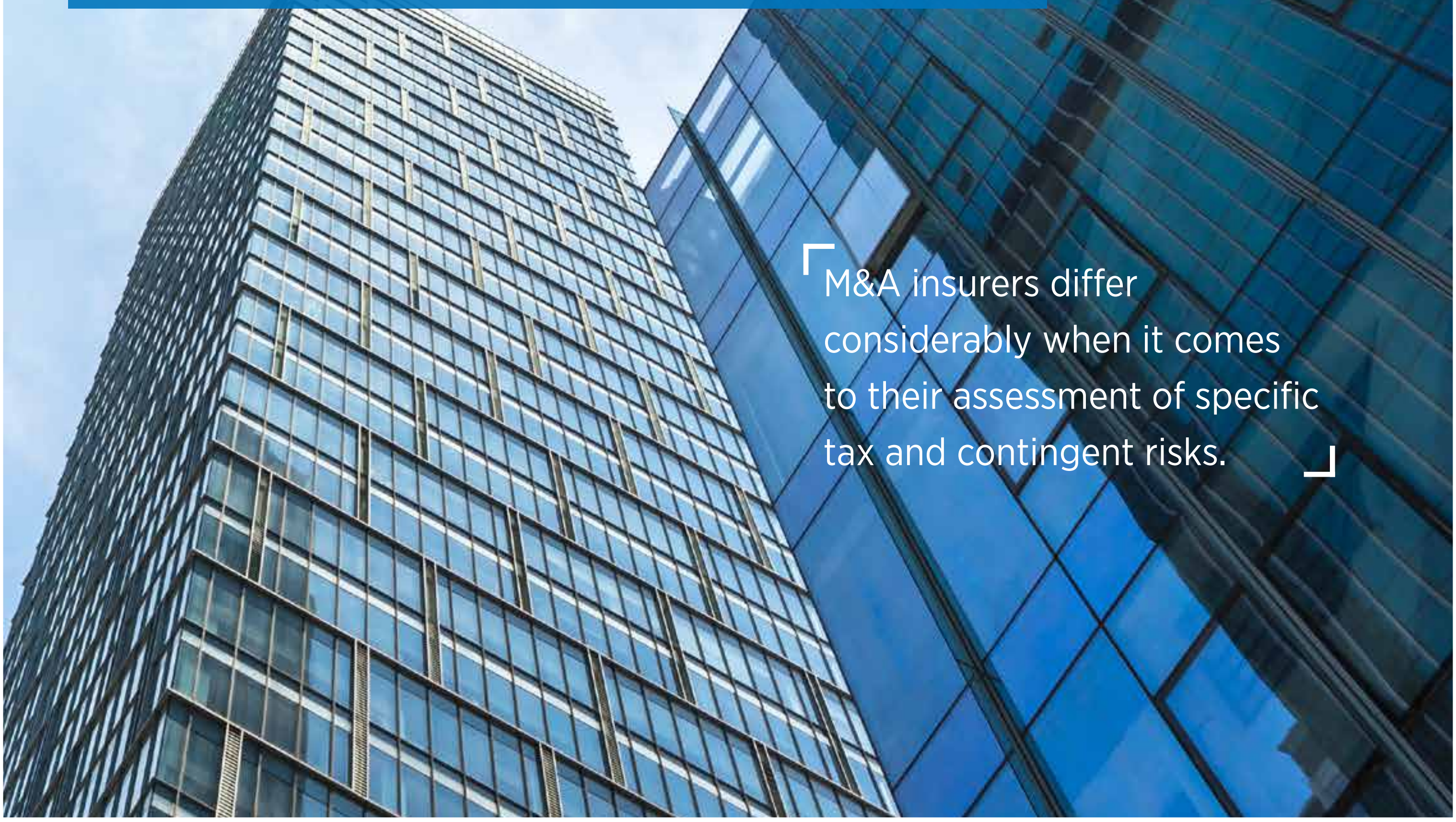
Tax & Contingent Liability

Tax and contingent liability insurance has predominantly grown out of the M&A insurance market. M&A insurers originally hired tax and litigation professionals to add an extra string to their bow, ultimately giving them more of a chance of winning more W&I / R&W placements. However, tax and contingent liability cover have become standalone products in their own right (comprised of about a third of Gallagher M&A policies placed in 2020).

Tax insurers are now relying on their own analysis rather than tax opinions provided by our clients, which has dramatically increased the chances of successful risk transfer. Difficult tax risks are now regularly being covered such as transfer pricing and the availability of tax assets, with less reliance on due diligence and pricing reports. High risk tax items and even pure discovery risks are also insurable in some cases. Now insurers have tax contacts in almost all jurisdictions, allowing them to understand the risks and provide quotes quickly for multi-sector and multi-jurisdictional deals.

M&A insurers differ considerably when it comes to their assessment of specific tax and contingent risks. Whilst some markets might take a view that specific matters are too risky to cover, others might have a more developed understanding of the concepts and applicable laws involved. It is therefore paramount to establish feedback from the entire M&A market in order to leave no stone unturned.



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2021 M&A Insurance Outlook

The M&A sector is expecting a significant bounce back. Many of our clients have built up substantial backlogs of capital, eagerly awaiting deployment on opportunities that have been created as a result of the pandemic. This could lead to a record number of transactions in 2021.

With other lines of insurance hardening in 2020, rates in M&A insurance have remained relatively stable (having decreased year on year over the last decade). This period of calm is expected to be short lived. Q1 treaty reinsurance renewals will be the first test for the M&A insurance market, which has already seen capacity providers pull capacity from MGAs this year. Pressure is also starting to build as profitability is threatened by an increase in claims frequency and a significant number of large claims paid. What is clear is that insurers are more likely to compete on coverage than price, which is certainly a reflection of the extensive enhancements M&A insurers have begun to offer. For example, coverage for distressed M&A (whether fully or partially synthetic) marks a radical change since the disclosure process and extensive DD exercises have formed the cornerstone of M&A insurance from the beginning. Cover for known risks is also likely to be a prominent feature of 2021 as insurers will not only need to differentiate themselves, but they will want to justify potentially higher premiums.

The claims process will be more prevalent than ever, allowing insurers and brokers to show off their services on a regular basis. Placement and claims experience is now a key component of an M&A insurance cycle that is starting to become a common part in the life of a fund or company. All in all, it will be a very interesting year for M&A insurance; whilst there are likely to be more transactions and opportunities to test the market's capabilities during the placement process, insurers' claims statistics will be eagerly analysed.

It must be said that the underwriting process continues to change for nil seller liability transactions, especially on GBP1bn plus deals, as both sides are starting to lean on insurers. The broker is therefore crucial; not only to act as a rational intermediary between a buyer and an insurer (who is effectively acting on behalf of the seller during SPA negotiations) but also during the claims process.

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Outlook Recap and Top Tips

Given how quickly the M&A insurance market has evolved and diversified over the last 12 months, it is more important than ever to keep the following items in mind when structuring M&A insurance coverage.

- **Are the most suitable M&A insurers being approached for your risk?** The Gallagher M&A team has no restrictions in approaching the global M&A insurance market for each deal. This can be up to 25 markets for one specific transaction; whilst this can be challenging at indications stage, it means we have the opportunity to compare every quote available, ultimately increasing competition so that the most attractive option can be presented in terms of premium, retention, execution risk and coverage.

- **Are tax, contingent, title and environmental risks being considered in tandem with the W&I cover?** The Gallagher W&I and R&W specialists work alongside tax, contingent, title and environmental brokers to make sure that any gaps in W&I or R&W cover (which arise from certain known risks and standard exclusions) are filled using other insurances available.

- **Does your broker have already agreed policy mark ups with each M&A insurer?** Given the speed of certain transactions, it is imperative not to waste time on initial negotiation of the front-end policy and use the valuable time to focus on the specific coverage position. At Gallagher, we have used the last four years to collaborate all the most insured friendly positions so that each market provides the widest coverage from the outset.

- **Does your broker have sufficient claims expertise and leverage with the insurance market?** Gallagher has a specialist M&A claims function, which is free of charge (when the policy has been placed through us). This team fights for claims to be paid and uses the leverage that Gallagher has in the market to do so (note that Gallagher controls USD26.5bn of insurance premium[1]).

1 Correct as at December 2020

M&A Insights

Over the course of 2020, the M&A team produced a variety of in-depth, relevant content on all areas M&A - from tax issues, to intellectual property risks, and everything in between. For more information, please view the resources below.

Transactional Risk Insurance for distressed M&A and special situations

Though distressed deals have been relatively common over the past few years, when there is a 'falling market' they become even more prevalent. Given the current economic downturn, insolvency, restructuring and distressed acquisitions will form a key part of M&A activity.

View article

Should cover for 'title to shares' be purchased in addition to Warranty & Indemnity (W&I) insurance?

When acquiring an operating business or a property in a corporate vehicle, our clients often ask whether it is sensible to purchase policies for both W&I and title insurance. Find out more in our article below.

View article

PPP Loan Insurance

Gallagher has developed Paycheck Protection Program (PPP) Loan Insurance for businesses that face uncertainty over whether they were eligible for their PPP loan.

View PPP loan insurance guide

View PPP loan insurance flyer

View PPP loan insurance webinar

Contingent Risk Insurance: Introductory Report

Contingent Risk Insurance (CRI) is mainly used in a transactional context, but Gallagher can also help with special situations such as disputes, liquidations and shoring up balance sheets.

View full report

Insuring the availability of tax assets

Working with Icen Risk, a specialist underwriting business dedicated to the M&A sector, we have developed an insurance product to provide protection for the availability of tax assets, which is especially useful for funds or other investors to use insurance to buy certainty on their return on cash-generative assets by locking in the value of tax assets in a target business.

View article

How COVID-19 has sparked significant innovation

Our panel of specialist M&A brokers, underwriters and insolvency lawyers discuss how the current economic crisis has allowed M&A markets to expand their appetites into areas such as Tax and Contingent Risk Insurance.

View webinar

State of the Market Report for global M&A Insurance

2019 proved to be the fifth record year in a row for the M&A insurance market with more products such as W&I, Representations and Warranties (R&W) as well as Tax and Contingent Risk becoming a staple part of the M&A insurance repertoire.

View full report

Are high risk tax items insurable?

Tax insurance has fast become one of the top tools considered by tax advisers and stakeholders faced with uncertain tax exposures. We have also begun to see tax insurers tackling harder, high risk tax exposures that were traditionally uninsurable.

View article

Does the buyer or the seller pay for Warranty & Indemnity insurance?

Whilst it is a commercial decision that is ultimately negotiated between the transacting parties, our clients often ask who should pay the premium and whether the costs can be 'sliced and diced'?

View article

IP Insurance: can businesses afford to ignore it?

Using patent disputes for illustrative purposes, a panel of experts from the USA, the UK and Germany discuss the transfer of Intellectual Property Risks (IPRs) with insurance. As these are often key assets, businesses are exposed to substantial risks of legal proceedings for IPR enforcement and invalidation.

View webinar

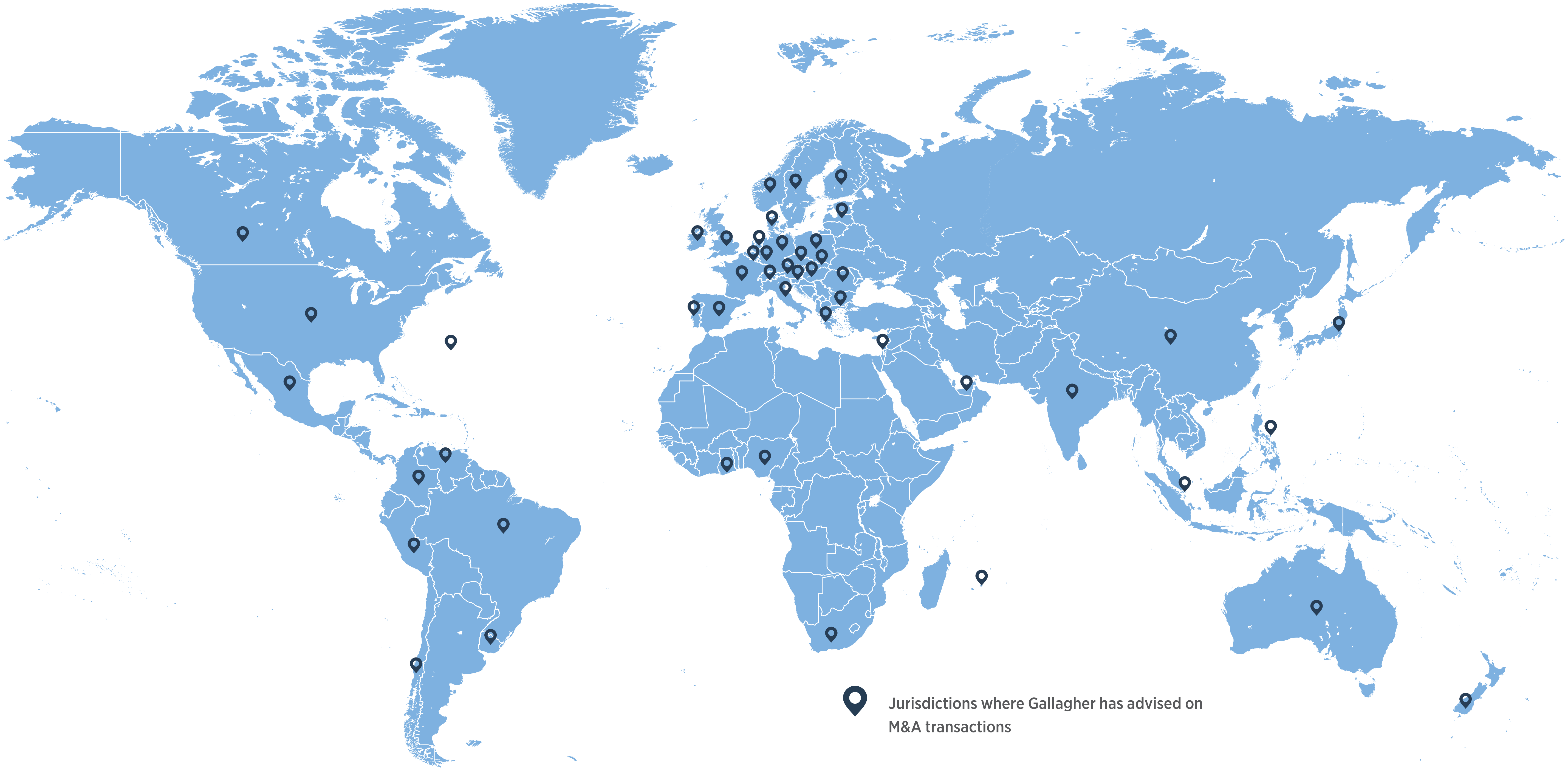
Why Gallagher?

Advised on
1000+
deals in over 40 countries since 2013

Advised on over
USD10bn
of combined deal value in 2020

Our specialists consist of qualified lawyers, brokers and insurance professionals who have a breadth of deal experience spanning a range of sectors and jurisdictions. Gallagher have also negotiated enhanced features of cover with the full W&I market, which are exclusive to Gallagher clients and which set our policy wordings apart. Our specialists will review all the legal, financial and tax reports with underwriters and push for as much coverage to be granted as possible.

As one of the world's largest insurance brokers, operating globally across a wide-range of classes of business, Gallagher place significant premium into the international insurance market. This means that in the event of a contentious claim, our brokers have considerable leverage and expertise to ensure that valid claims can be resolved in our clients' best interests.



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ARTUK-1800 | FP1607-2020 Exp. 05/01/2022.

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