Global M&A 2021 Review and 2022 Outlook

JANUARY 2022

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 32,000 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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Executive Summary

2021 proved to be a fascinating year in the world of M&A insurance, and indeed M&A as a whole. Though ongoing lockdowns across the world have disrupted some deals, M&A activity has on the whole grown significantly throughout the year, with no signs of the respite we saw during mid-2020.

As discussed in our last annual report, M&A insurers used the lull in 2020 to reflect, reassess and innovate in order to prepare for the inevitable bounce back as the global economy improved. Almost every M&A market expanded their team, not just to add weight to their Representations and Warranties (R&W) and Warranty and Indemnities (W&I) offering but also to differentiate themselves with expertise in areas such as tax, IP and contingent risks. Whilst ex-corporate lawyers traditionally have made up the bulk of M&A brokers and underwriters, a greater number of accountants and bankers have been welcomed into the fold, giving insurers fresh perspectives when it comes to assessing transactional risk.

The M&A insurance market was well prepared for 2021. The year has been the busiest on record. Even though all c. 35 insurers were better staffed for the onslaught of transactions (especially from Q2 onwards) the sheer volume was unprecedented and actually led to what could be described as a 'hard market', after many years of reducing premiums.

Whilst claims have not necessarily outweighed premiums (which is how hard markets are traditionally established), capacity in the M&A market started to dry up towards the beginning of Q4. In other words, many insurers had to shut their doors by October as they had effectively written too much business and Managing General Agent's (MGA) capacity providers were not willing to 'extend the tape' any further. This inevitably pushed up premiums and restricted appetites as those that still had capacity were able to 'pick and choose' the deals they wanted to underwrite. Brokers needed to be very strategic in their marketing approach and leverage was used to squeeze out terms from insurers.

Despite tightening market conditions, we have seen some insurers expand into some territories and sectors that were traditionally considered uninsurable. While mid-market private equity led transactions in more established jurisdictions drove the market, some insurers still wanted to focus on deals in emerging jurisdictions. South America and South East Asia have boomed recently, with high premium rates attracting insurers. Rate, lack of stiff competition, and in-house industry-specific expertise have encouraged some insurers to move into slightly higher risk sectors, such as FI and mining.

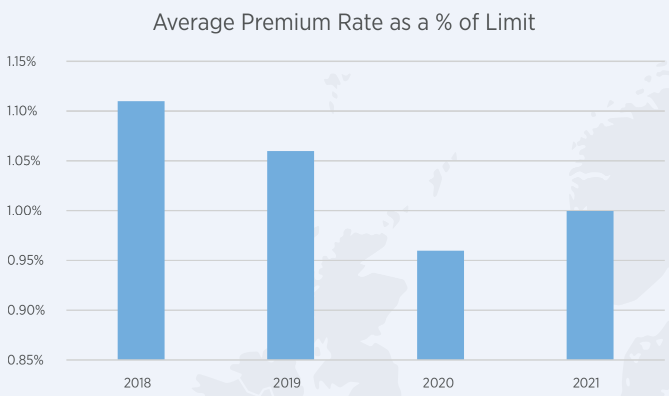
Although it was only last year, it seems a long time ago that the W&I market was loudly promoting fully synthetic policies as a solution for distressed M&A and liquidations. An economic recovery in 2021 and heavy government support for businesses limited the number of such transactions where fully synthetic policies could be tested, however we have nevertheless placed several in 2021. Although these are more expensive and do often require the sell-side's co-operation and engagement in the process, they may incrementally become more common throughout 2022.

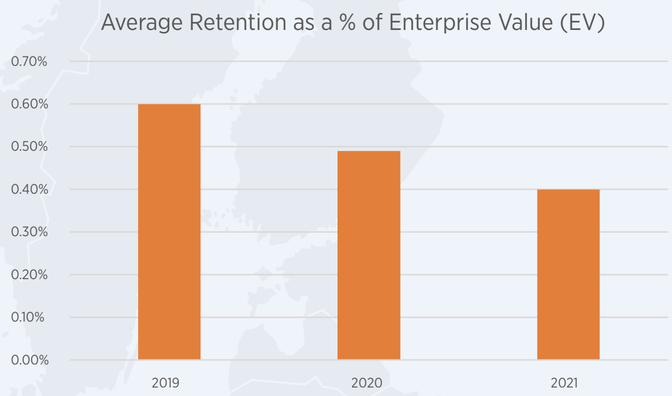
Claims service remains paramount. Insurers continue to differentiate themselves by releasing claims data and hiring claims experts to assist brokers and clients alike. It is very important to be able to demonstrate experience and expertise in this area as it has become one of the leading questions we receive from clients when asked to recommend an insurer. Since the percentage of notifications and claims has crept upwards, brokers need to place more weight on insurers' claims handling experience.

It has been an extraordinary year. On the one hand, some insurers have widened their appetite into new sectors and jurisdictions, and on the other hand the sheer volume of deals has meant that other insurers have had to slightly delay broadening their appetites so that they can service the more 'bread and butter' transactions.

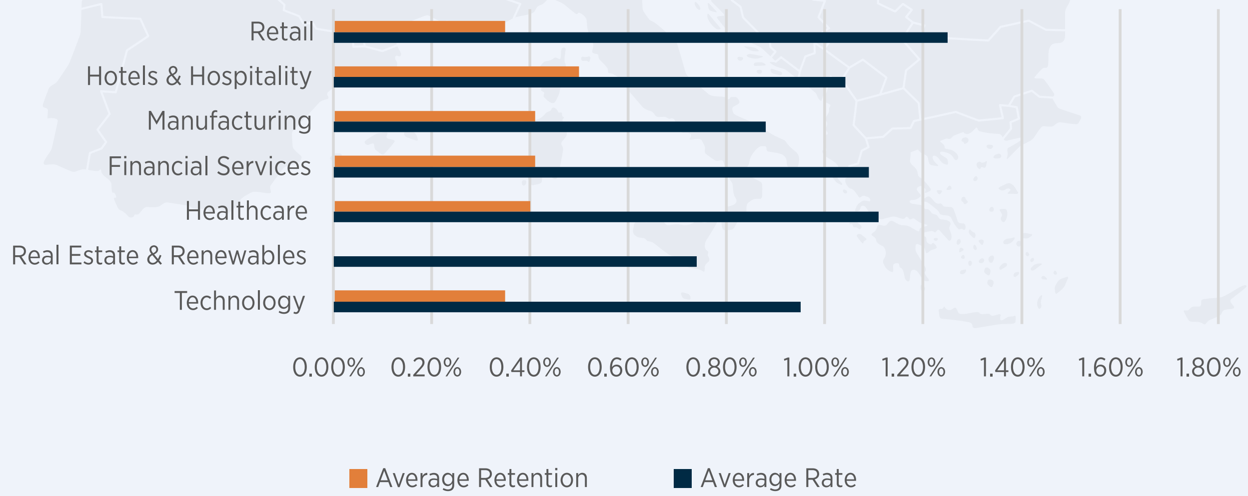
Despite tightening market conditions, we have seen some insurers expand into some territories and sectors that were traditionally considered uninsurable.

UK & EEA





Specific Sectors – Average Premium Rates and Retention Rates



Specific Jurisdictions – Average Premium Rates: 2021 v 2020

Premium rates have risen c. 10-15% due to the lack of capacity during the end of 2021, with increases most notable in small-to-medium transactions. Most underwriters raised their minimum premium levels as well, in some cases to GBP 250,000, although there are still insurers specialising in SME deals (with minimum premiums of c. GBP 40,000).

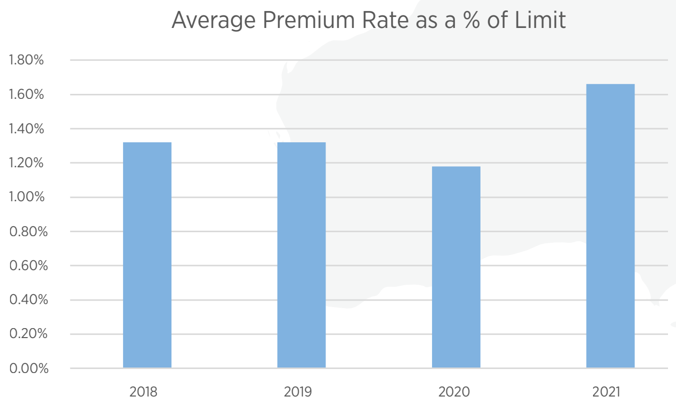
In terms of different jurisdictions and sectors, the scope continues to widen due to insurers' expertise and experience with local counsel. Insurers can now theoretically insure almost all jurisdictions in Europe (and can often match the governing law under the policy) but deal sizes often need to be relatively substantial in order to satisfy insurers' minimum premium requirements. Some insurers have expanded their SME offering to other European destinations, including Eastern Europe, meaning that for certain low risk transactions, premium pricing once only seen in the UK market is increasingly possible.

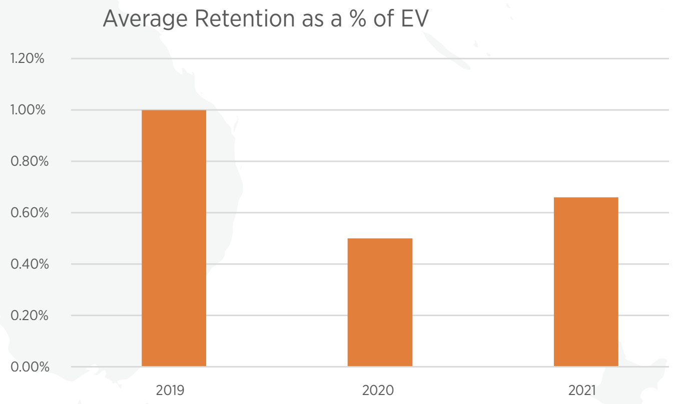
Few sectors are outright uninsurable now. FI, mining, construction and high-tech deals are being regularly covered. Corporate real estate continues to attract low premium rates (as low as 0.55% in one recent exercise we conducted). Increasingly known tax issues in real estate transactions can be 'wrapped' into the W&I policy, pushing the premium up (but enabling a solution in circumstances where neither party is willing to assume a particular tax risk).

Retention rates have remained steady (in some cases these have actually reduced); with nil excess levels remaining flat across corporate real estate deals, manufacturing deals attracting rates of c. 0.25% - 0.5% and FI deal rates between 0.5% - 1%.

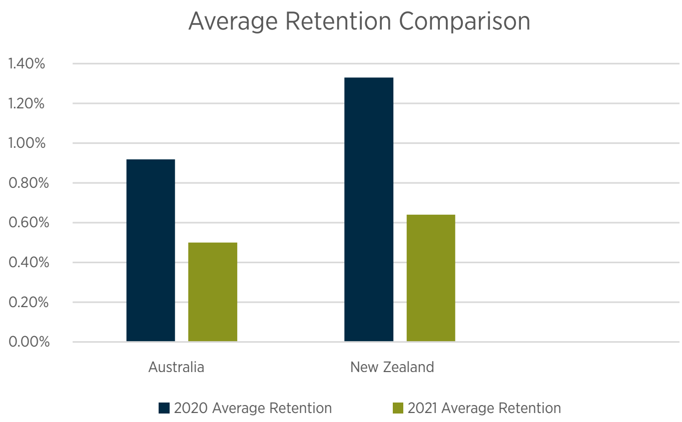
For the larger deals, although up to GBP 750m+ is theoretically still available, insurers have tended to lower their maximum line sizes (smaller layer sizes have historically been deployed in the US market). Primary lines of c. GBP 20m – 30m are much more common now for deals involving operating businesses, meaning that more players need to be involved in any given large transaction, each contributing to an insurance tower. For real estate deals however, it remains the case that some markets can put up as much as GBP 200m for one deal.

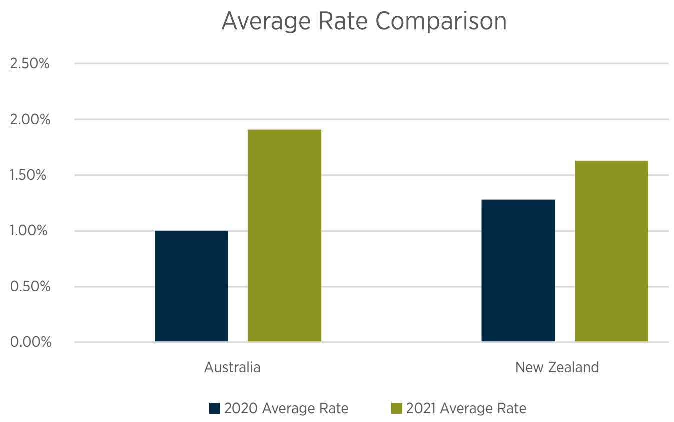
Australasia





Specific Jurisdictions (Australia & New Zealand) – Average Premium Rates and Retention Rates



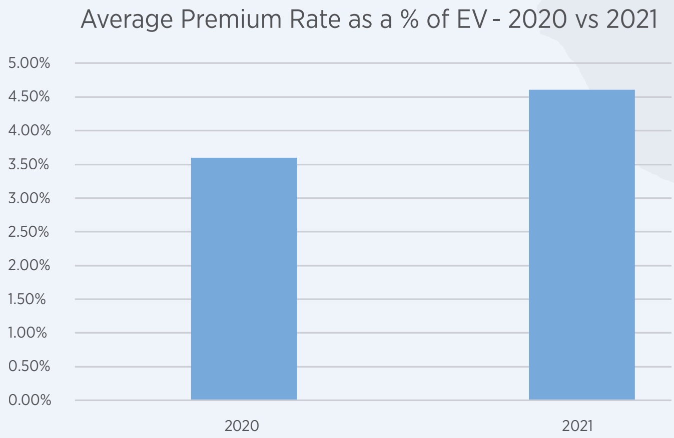


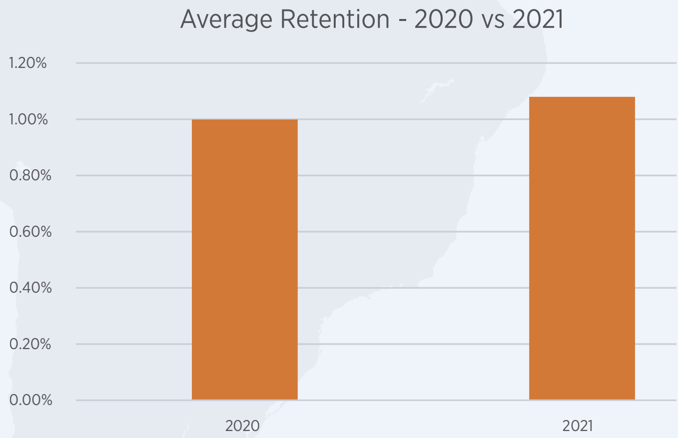
Both Australia and New Zealand have seen another dramatic uptick in the use of W&I insurance. Even though UK domiciled insurers have entered the Australian market (thus increasing competition), premium rates have still risen such has been the increase in demand. It has therefore become very important to utilise the UK market to source terms.

Minimum premiums have increased slightly to AUD 150,000 – AUD 175,000 due to the lack of competition in the SME market, although underwriting sophistication and expertise has evolved markedly over the last few years. Internal financial DD, for example, can now be accepted on occasion, as insurers have a good grasp of what to look out for.

For larger Australasian transactions, we would expect at least c. AUD 500m of capacity to be available.

South America





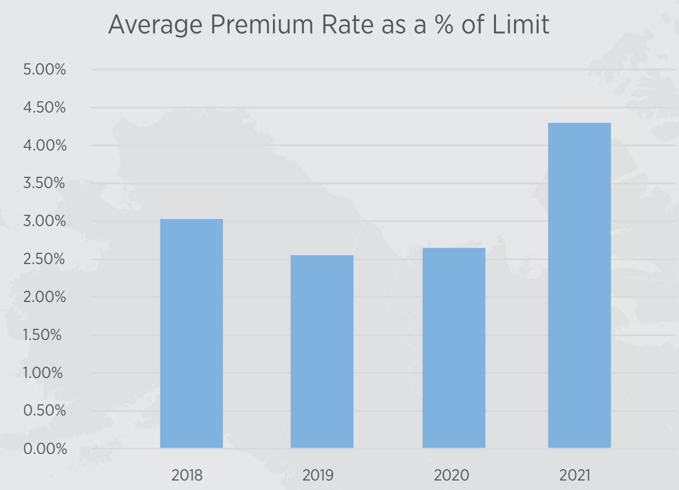
R&W insurance in South America has really taken off over the last 18 months. The knowledge and expertise in the area has allowed insurers to take more of a pragmatic approach when it comes to underwriting and policy negotiation. In particular, insurers are becoming much more flexible when it comes to matching the governing law of the SPA, and integrating various enhancements (such as removal of the dataroom from the definition of "disclosed") into the policy.

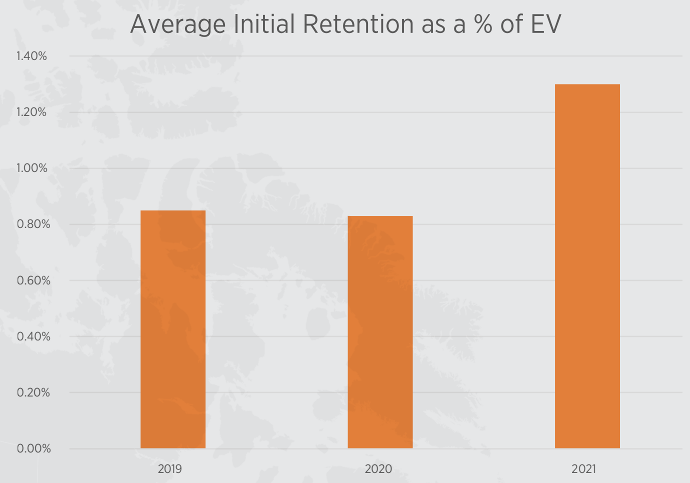
Whilst there were perhaps one or two markets that were willing to look at South America a couple of years ago, at least 5-10 insurers are now competing. Although we are facing a harder market in the rest of the world, the boom in competition for South American transactions has kept premiums steady.

Many countries in South America are insurable, although some countries are easier than others. Uruguay, Peru, Mexico and Chile are probably the most attractive to insurers (with broad coverage for litigation and tax cover likely) whereas Argentina, Columbia, Paraguay and Venezuela are likely to be out of scope. Brazil, Bolivia and Ecuador are certainly possible to insure but coverage may be restricted (for some sectors).

Premium rates fluctuate per jurisdiction and sector but these are likely to be between 4% - 6%. Retention rates remain stable at 1% (and are unlikely to be able drop after 12 months to match a US law sale agreement).

USA and Canada





In the USA and Canada, R&W tends to be three times more expensive than other established jurisdictions, like Western Europe. This is due to a combination of demand, a more active claims environment and broader coverage.

The main coverage differences are that the data room and due diligence reports are not disclosed, seller knowledge is scraped, indemnity basis damages and there is no De Minimis.

In 2020, we saw average primary layer rates creep above the 3% mark for the first time since 2017. This was driven by increased severity of claims and record demand in the second half of the year as M&A picked up after initial COVID-19 lockdowns.

This narrative continued into 2021 and reached a peak after the summer break with quoted primary rates ranging from 4.5 - 7%.

Cumulative paid claims and losses in certain industries (such as healthcare) were a contributing factor but the material increase was down to the sheer volume of deals in 2021. For one insurer, in the 90 days to November they received almost 2,000 R&W submissions. This allowed insurers to narrow appetite and increase rate without losing good opportunities in the process.

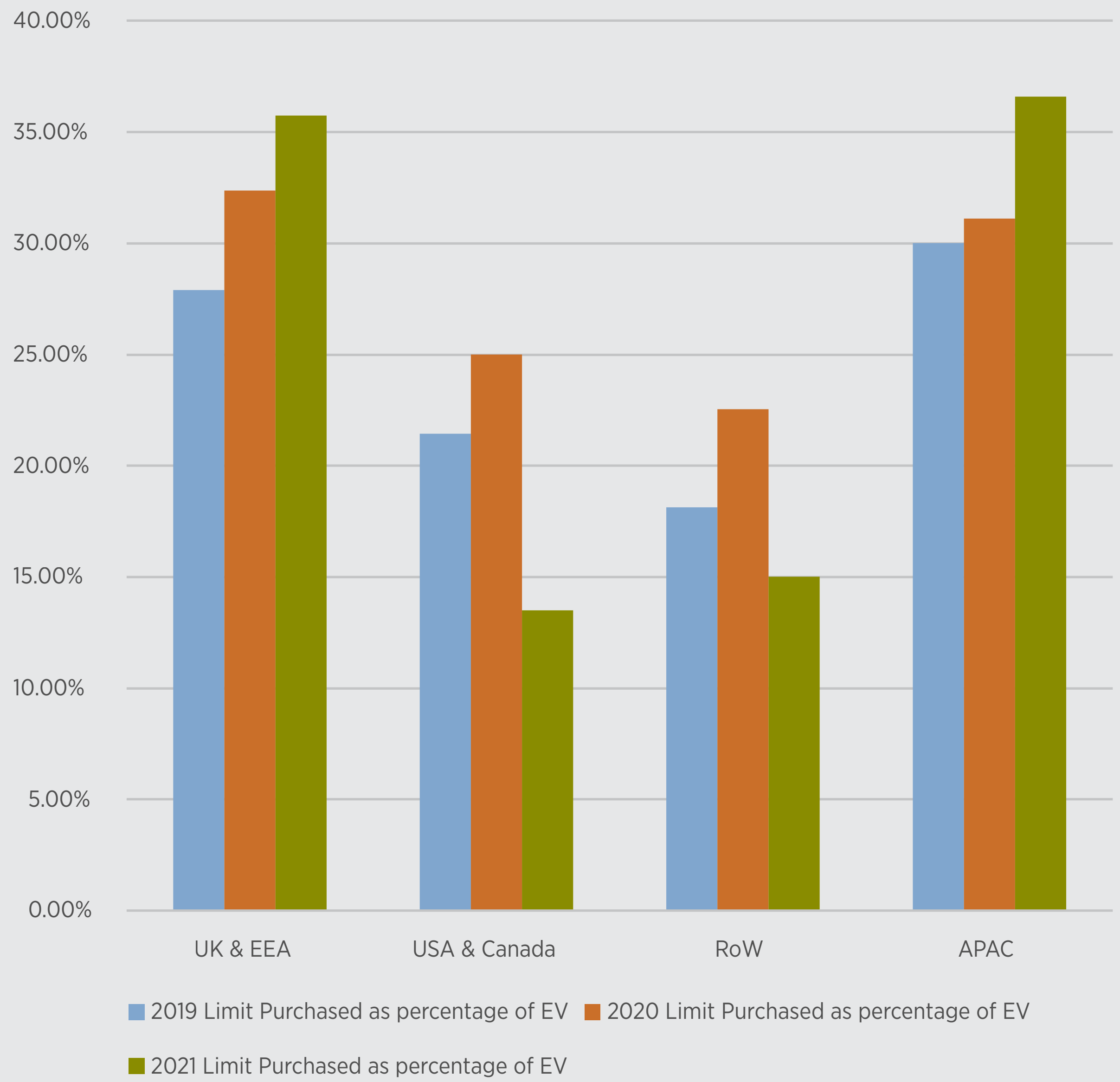
Whilst average quoted rates have gone up, in nearly every case, Gallagher were able to bring them into line with the market, or lower, based on our market data. Our average bound primary rates are therefore lower than the average quoted rate

Retentions have remained flat in 2021 with the average for deals under $200m being 1% dropping to 0.5% after 12 months. Above $200m some insurers may offer 0.75-0.85% dropping to 0.5%, for certain industries (like real estate & renewables, retail and manufacturing).

Technology and Healthcare have seen more of a squeeze with increases in rate driven by markets pulling out of the sector. In some cases retentions have crept above 1% in healthcare and technology sectors (and as high as 2% for deals under $30m). We are yet to see fixed retentions but there are some who are not offering terms with nil seller indemnity.

The maximum capacity for one deal is about $750m, although insurers have certainly begun reducing their line size (to perhaps $25m - $30m). As such, for the larger deals, the whole R&W market is likely to be utilised.

Global Average Limit Purchase as a percentage of EV



As you will see, the amount of insurance purchased as a % of EV has increased in Europe and the APAC region during 2022. Whilst premiums have also increased, this rise in the average limit is likely to be down to experience with claims processes and an increasing notion that the product works.

In North America and the rest of the world the average limit as a % of deal value has slightly decreased, which is almost certainly down to the size of deals Gallagher has recently advised on. In 2019-2020 the average deal size in North America and the rest of the world was less than $100m, meaning that minimum premiums drove higher limits. In 2021 the average deal size has been north of $250m, which alongside the rising premiums, has led to lower limits being sought.

Tax Liability Insurance

Despite the hardening W&I and R&W market, the Tax Liability Insurance market has remained competitive with many insurers expanding their tax offering, not only by hiring additional 'man power' but broadening their underwriting appetite.

With this influx of competition, insurers have also begun to consider submissions from a wider range of jurisdictions (anywhere with a stable rule of law). This year we have successfully placed specific tax risks which have been rated as 'medium' and 'high' risk by our client's tax advisors. Certain categories of notoriously complex risk, for example transfer pricing, are increasingly being covered by underwriters with sufficient expertise to conduct their underwriting in-house.

Insurers used to only focus on corporate tax matters, given uncertainty over individual tax planning. Over the last year, we have seen an uptake in placements for personal tax matters such as Transactions in Securities, EMI schemes and transitional provision risks (amongst many others) being insured.

The COVID-19-induced logistical difficulties of receiving tax rulings in many jurisdictions increased demand for insurance as an enabler of certainty. Legal changes also continue to drive trends. Certain risks that were starting to become almost commoditised – Polish VAT/CLAT and German Real Estate Transfer Tax for example – have become more challenging due to judicial and legislative developments. On the flipside, we expect that the OECD-sponsored refurbishment of global corporate tax frameworks, and renewed efforts by governments and tax authorities to chase revenue, will also create opportunities for tax insurance to evolve.

Contingent Risks Insurance

Contingent Risk Insurance has historically been used to address known matters identified in a buyer's due diligence, that neither buyer nor seller wish to bear, and therefore cause a roadblock in an M&A transaction. A bespoke policy is a way of ring-fencing such a liability.

Whilst the contingent markets indirectly benefitted from a buoyant M&A market in 2021, we are increasingly seeing their use in a wider variety of contexts, including (re-)financings and corporate re-organisations, fund wind-ups and insolvencies – wherever a (low probability) risk could have very material negative impact were it to materialise.

Contingent risk insurers in particular focus on the motivation for seeking insurance, just as much as the jurisdiction, quantum and legal arguments at play. The product is well suited for circumstances where taking a certain issue off the table will provide our client with a compelling significant strategic advantage (rather than just managing downside risk). Contingent risks often arise in a situation where the seller, purchaser or beneficiary is comfortable with a risk, but a related party to a corporate finance activity (e.g. a financier, or liquidator) is not. In 2021 we have seen this dynamic play out in enquiries relating to problematic planning consents for infrastructure projects, pensions, and active or threatened litigation.

We expect significant further growth in 2022, as word spreads as to what is possible to insure, and the risk appetites and resources of insurers continue to expand.

Title Insurance

The Title to Shares market remains buoyant with up to USD 1 billion of capacity. There are however limited insurers writing this product. DUAL and Axa are the only insurers who can provided a Title to Shares product only. CLS and First Title need Real Estate to be attached to the transaction in order to provide cover; this is due to their binding agreements.

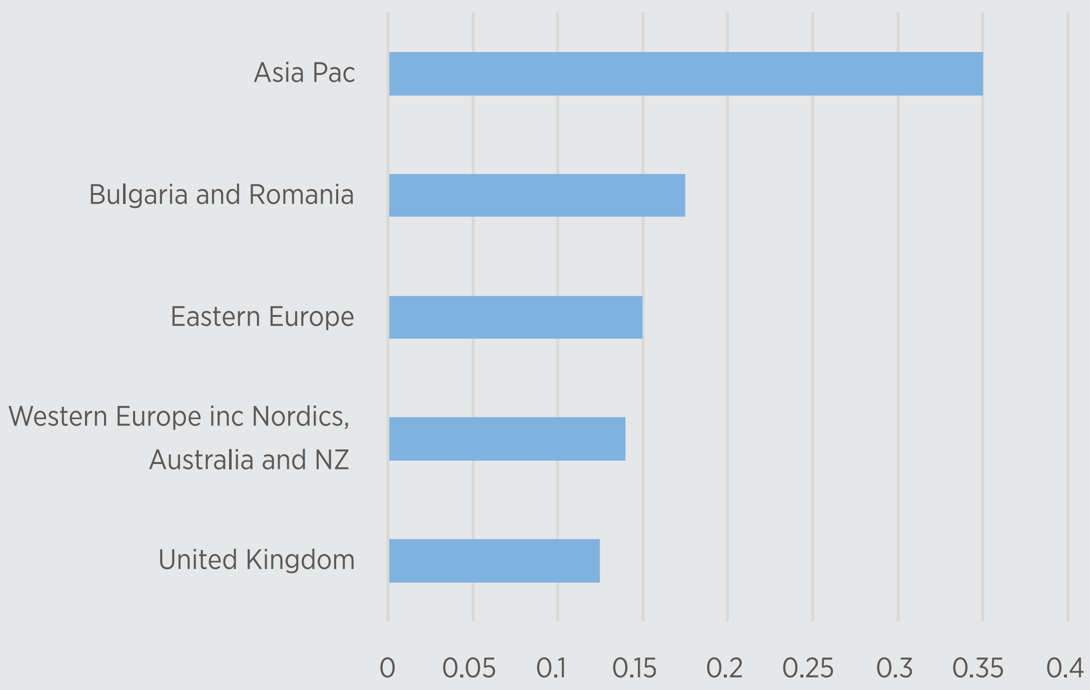
Though there is capacity, the limited pool of insurers could create a monopoly. However, we have not seen rates rise as a result of this and we anticipate that rates will remain competitive, rather than harden in the next 12 months.

Though Fundamental Warranty cover is available, again, this can only be placed by a limited number of insurers. There is a possibility of a new entrant to this market in 2022, which will enhance competition and likely drive rates down.

Title to Shares and Title to Real Estate cover has remained competitive in 2021, enhancements to cover are usually being included for no additional premium and the availability to include known risks is the main area where insurers are adding value.

The territories we have seen most clients purchasing cover are mainly Eastern and Western Europe and Australia. With sellers being able to cap liability and not needing to stand behind Fundamental Warranties, we are seeing this product being used as a deal facilitator, particularly where a fund or risk averse seller is involved.

Average Premium Rates per Territory



Average Rates for Title to Shares Cover only

Intellectual Property Infringement Liability

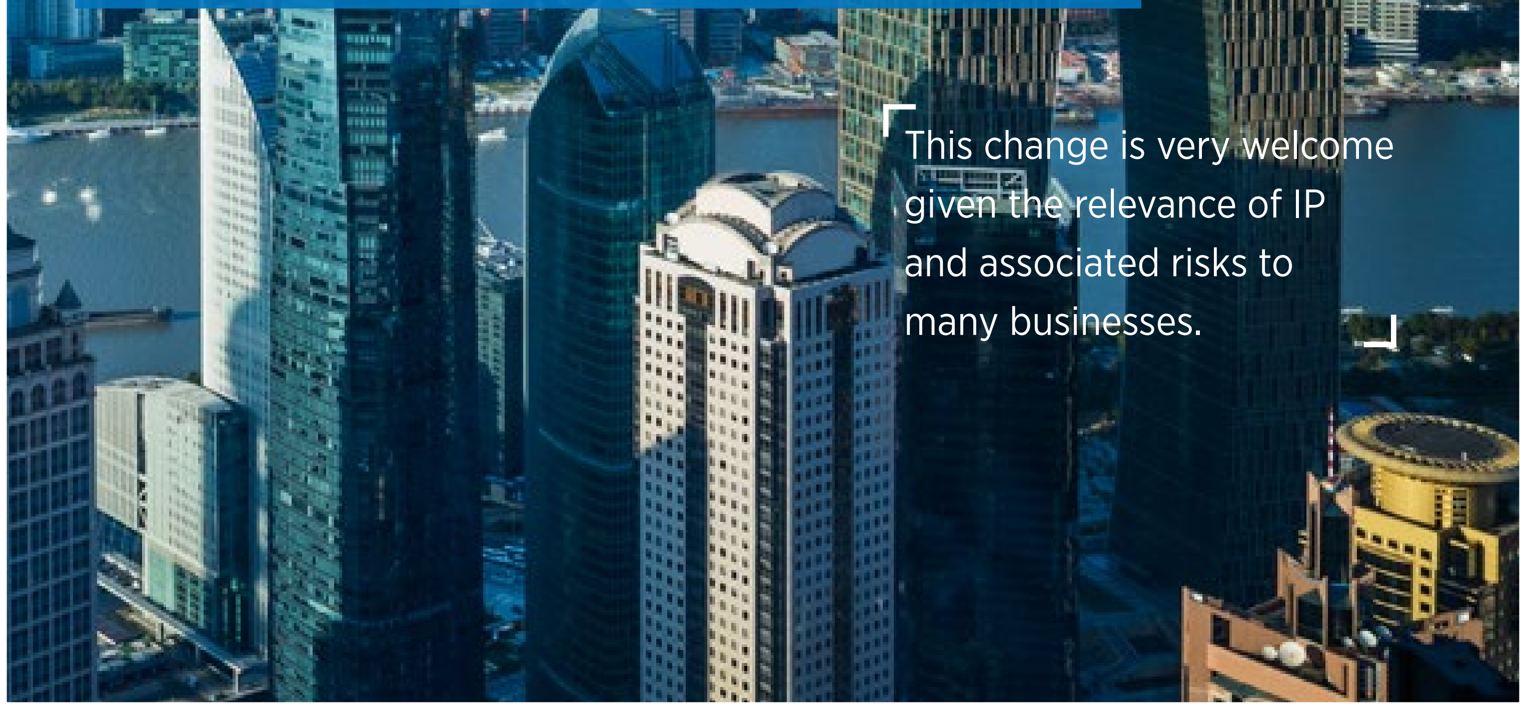
Intellectual property (IP) infringement liability insurance may be available on a stand-alone basis, and is sometimes considered alongside a W&I or R&W policy. It can pick up on potential gaps of cover where no warranties are provided in case of future allegations relating to historic infringement, and the policy can also cover infringement claims arising out of activities commencing after the day of the acquisition.

Another common reason for purchase of this coverage is to protect against risks arising out of sales or licensing agreements, where the insurance can provide cover for the insured's obligations to defend or indemnify customers or licensees for IP matters.

An IP infringement liability policy is usually provided on an annual basis, covering the legal costs and potential damages arising out of infringement allegations first made during the policy period. The product class has been available for some time, but over the past decade the market has developed, with new underwriters and with overall capacity increasing. This change, enabled by increased access to IP data and analytics for underwriters, alongside more specialists entering the market, is very welcome given the relevance of IP and associated risks to many businesses.

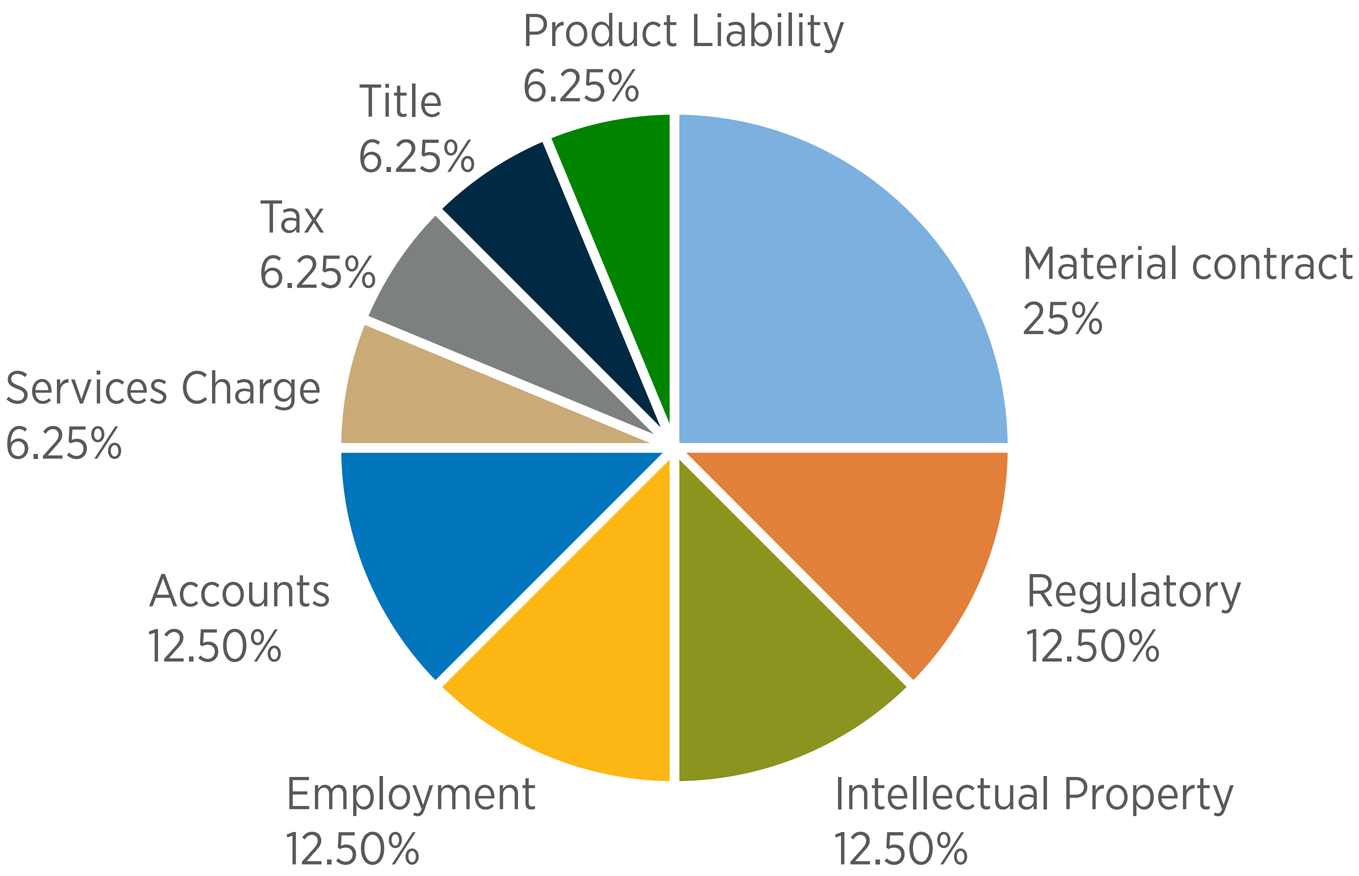
Underwriters in the market may focus on different market segments and the coverage will also differ somewhat, so it is important to know the whole market and to seek feedback from the relevant parts of what is still ultimately a niche market place.

Between Gallagher's M&A and IP teams we can collaborate to find out what is available and most suitable in each scenario.



This change is very welcome given the relevance of IP and associated risks to many businesses.

2020 – 2021 M&A Claim Notifications



Gallagher's specialised M&A Claims Team has seen W&I / R&W notifications increase year on year since 2017.

> In 2021 Gallagher successfully advised on claims payments in excess of GBP 10m.

Conclusion and 2022 Outlook

2021 was not a typical year in M&A insurance, nor M&A as a whole. Although claims activity has certainly increased, the sheer deal volume has overwhelmed the market, driven rates up and in some cases forced insurers to shut their doors due to lack of capacity.

Although deal flow is likely to remain high in 2022 Gallagher anticipates a slight drop, on the simple premise that 2021 effectively encompassed two years of deal activity. If activity does drop (even slightly) rates are expected to drop off too.

Given the successes 2021 has brought, insurers will have big budgets for 2022 and will be under increasing pressure to win deals. Even if deal flow was to remain as high as 2021, new entrants will inevitably enter the fray and existing M&A insurers will continue to expand their teams, which at the very least should keep rates steady through 2022.

Transactional risk insurance is continuing to mature and cement its place as a valuable component of how M&A is done. 2022 will be another busy year and we expect that there will be more exciting trends to report on this time next year as the product develops even more.

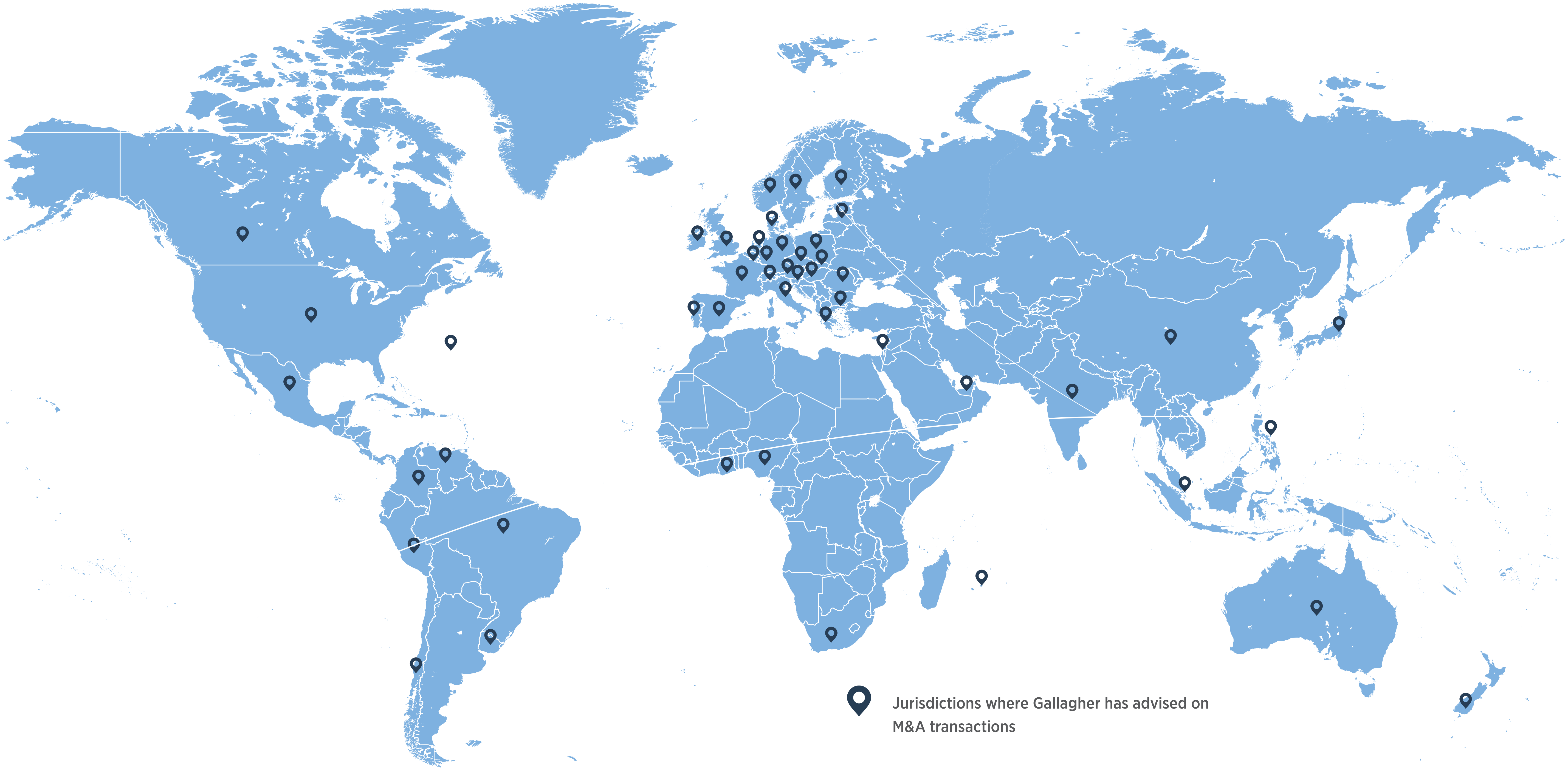
Why Gallagher?

Advised on
1000+
deals in over 40 countries since 2013

Advised on over
USD15bn
of combined deal value in 2021

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 has 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 places 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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