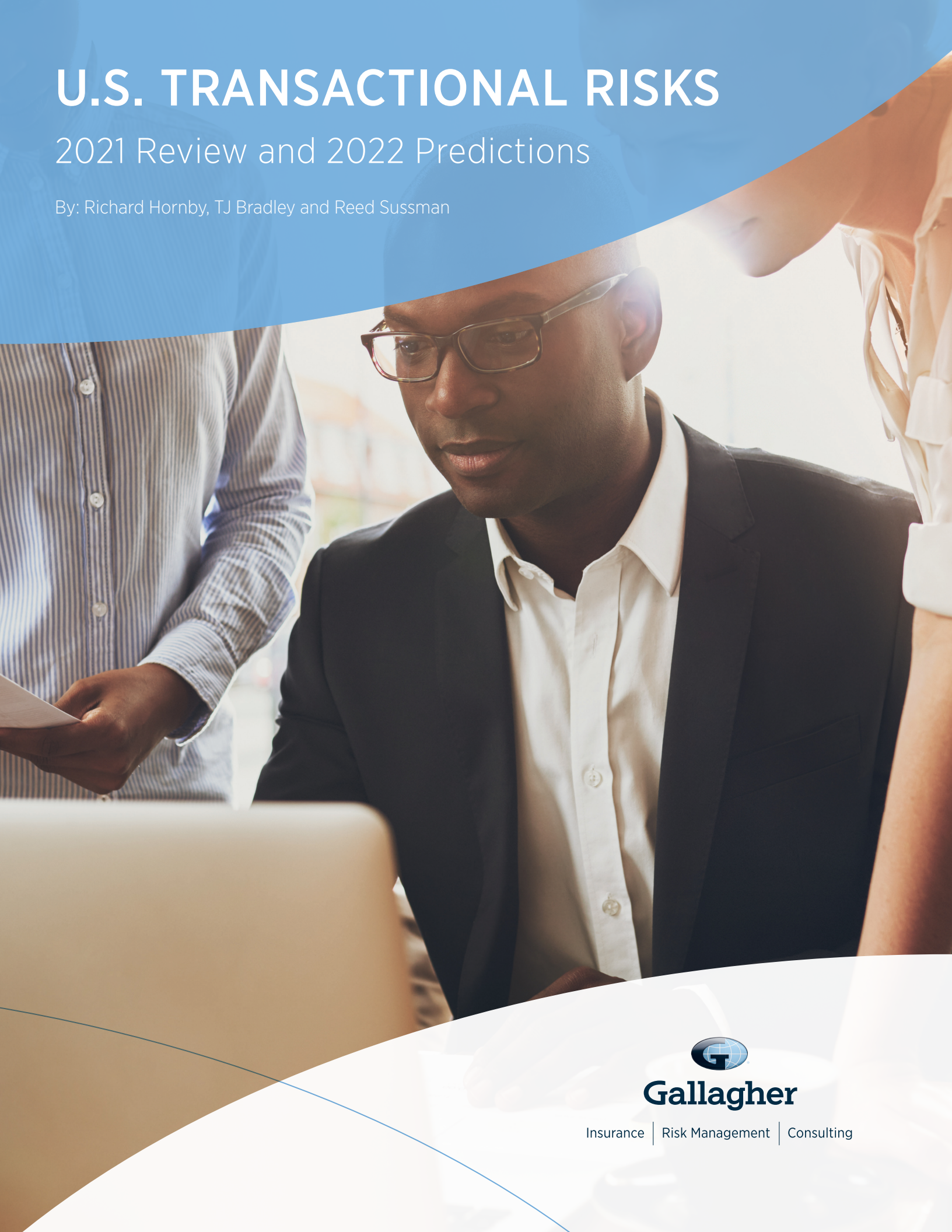


U.S. TRANSACTIONAL RISKS

2021 Review and 2022 Predictions

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Introduction

2021 has been one of the biggest years for U.S. Mergers & Acquisitions (M&A) deal volume on record, and certainly in the life of representations and warranties insurance (RWI). We have seen RWI rates nearly double over the course of the year and RWI insurers attempting to restrict coverage in response to increasing claims experience. RWI is now a staple part of the majority of U.S. M&A deals, and new product developments are enabling it to reach previously uninsurable deals. We are also continuing to see growth in the use of tax, contingent liability and other insurances, which can assist not only M&A but a broad range of standalone risks generated by transactional situations. The following report provides the latest costs, developments and projections for transactional risk products in 2021/22.

Overview

- Primary RWI rates to remain at 4.0%-6.0% for most sectors with a slight rate decrease in early 2022.
- Rates are likely to stabilize at 3.5%-4.5% for most sectors in late 2022.
- Underwriters are leaning harder on insurance due diligence and underlying group/target programs.
- Integration and sale preparation are expected to increase in 2022 and could contribute to a decrease in deal volumes experienced in 2021.
- Greater contingent and tax liability insurance inquiries due to integration and sale preparation.
- Fundamental Representations Insurance on the increase in 2021 (standalone and excess “top-up”).
- Broader deal ranges are insurable due to the development of small business RWI.

Representations and warranties insurance metrics

Average bound primary rate as percentage of limit

- Annual: 4.3%
- Minimum Premium: \$150,000-200,000
- H1 2021: 3.4% (quoted range 3.0%-4.0%)
- H2 2021: 4.5% (quoted range 3.8%-8.0%)

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12%

OF DEAL VALUE AVERAGE
INSURED LIMIT



4.5%–8%

2021 PRIMARY
RWI RATE RANGE

2021 was a tale of two halves as RWI rates almost doubled in the second half of the year. The statistics above illustrate January–June (H1 2021) and July–December (H2 2021).

In 2020, we saw bound primary RWI rates creep above 3.0% for the first time since 2018. This was driven by increased severity of claims and record demand in the second half of the year. This narrative continued into 2021 and reached a peak after the summer break, with quoted primary rates ranging from 4.5%–8.0%. Minimum premiums also rose to \$200,000.

Financial, healthcare and technology deal volumes were up in 2021 and saw significant RWI price increases, occupying a quoted rate of 5.0%–8.0% by the second half of the year. Healthcare deals with exposure to billing and coding, and technology deals with exposure to Professional Services Liability (E&O) saw some of the highest rates.

Despite the dramatic increase in RWI rates and fewer insurers competing for the same deals, Gallagher's average bound primary rates were lower than average quoted rates. In some cases, we reduced the premium rate for the most attractive quotes using our extensive market data. In addition, towards the second half of the year, nearly all U.S. insurers were prioritizing submissions for repeat buyers and, in many cases, a strong broker relationship was necessary to secure insurance at a competitive rate.

Average bound limit for representations and warranties insurance as a percentage of deal value:¹

- Average: 12.0%
- \$200 million+: 10.0%
- \$100 million–\$200 million: 10.0%
- \$30 million–\$100 million: 12.0%
- \$0–\$30 million: 21.0%

Despite the increase in rates, clients have continued to increase the average insured limit for RWI. This is supported by recent claims data from AIG, which suggests that the average claim size for deals over \$10 million is \$19 million; our own experience also suggests the average paid claim exceeds ten percent of deal value.

Average retention as a percentage of deal value:²

- Initial 1.0% dropping to 0.5% after 12 months for all sectors
- Initial 0.75%–0.85% dropping to 0.5% for large or favourable deals
- Minimum retention: \$150,000–250,000+

Retentions have remained flat in 2021, compared to 2020, with the average for deals under \$200 million being 1.0% dropping to 0.5% after 12 months (another sign that rate increases were not so closely linked to claims exposure). Some insurers may offer a lower initial and dropping retention rate for large deals or certain industries (including real estate and renewables, retail and manufacturing).

In some cases, retentions have crept above 1.0% for deals under \$50 million and for less favorable sectors (including financial services, healthcare and technology). Fixed retentions remain uncommon, although for smaller deals a fixed retention may be appropriate due to minimum thresholds.

¹Excluding fundamental top-up insurance.

²Including underwriting fee, fundamental top-up insurance and premium tax. Excluding affirmative cover for known risks or add-on transactional risk products).



0.6%

AVERAGE TOTAL COST
OF RWI AS A PERCENTAGE
OF DEAL VALUE



1 in 5

RWI POLICIES
NOTIFIED



2 in 3

CLAIMS EXCEEDED
10% OF
DEAL VALUE
(<\$100M)

Average total cost as a percentage of deal value :

- Average: 0.6%
- \$200 million+: 0.4%
- \$100 million–\$200 million: 0.48%
- \$30 million–\$100 million: 0.55%
- \$0–\$30 million: 0.98%

An important statistic is how much our clients are spending in total on deals, including underwriting fees and taxes. This can provide a rough estimate for budgeting as well as an indicator of how much RWI is costing as part of the deal.

Representations and warranties insurance coverage

One of the main coverage themes for 2020 and 2021 was the RWI market's effort to disentangle from cyber, E&O and environmental exposures by including general exclusions. To remove these exclusions, insurers have started to request that not only underlying coverage be in place but a minimum level of limit is purchased in order to remove general exclusions from the RWI coverage.

It is also imperative to clarify the RWI position at quote stage whenever “excess only” or “no broader” cover is raised by the RWI underwriter, in relation to a target's existing insurance policies. In some cases, these coverage limitations can be removed altogether.

We still expect COVID-19 exclusions to remain a feature of policies in 2022. The broad “business interruption” style exclusions we saw in early 2021 have largely been paired back, in most cases, to bodily injury and non-compliance with COVID-19 legislation, subject to sector exposure.

The market has responded to large losses driven by multiplied damages by looking more closely at deal valuation methodology. In some cases, insurers reserve the right to exclude multiplied damages claims, although not seen on any of our policies placed in 2021.

Representations and warranties insurance claims

Our rate of notifications is one in five RWI policies, with between 10%–20% of notifications leading to a paid RWI claim. The rate is flat compared to 2020, but the number of claims has increased due to the cumulative growth of RWI policies placed year on year.

Some of our largest paid claims are linked to key customers, revenue recognition and accounting. On sub \$100 million enterprise value transactions, we saw claim value exceed ten percent of the deal value on nearly two-thirds of claims. In all cases, we reached swift resolution and continue to work closely with our repeat markets who have paid out in the past.

A circular infographic with an orange background. It features a large white number '23' at the top. Below it, in white capital letters, is the text 'NUMBER OF INSURERS OFFERING PRIMARY RWI'. The background of the circle shows a blurred image of a person wearing glasses and looking at a document.


23

NUMBER OF INSURERS
OFFERING
PRIMARY RWI

A circular infographic with a green background. It features a large white number '\$750M' at the top. Below it, in white capital letters, is the text 'AVAILABLE RWI CAPACITY FOR ONE DEAL'. The background of the circle shows a blurred image of a person's face.

\$750M

AVAILABLE
RWI CAPACITY FOR
ONE DEAL

A circular infographic with a grey background. It features a large white number '\$200K-\$10M' at the top. Below it, in white capital letters, is the text 'DEAL VALUE'. Above the number, in white capital letters, is the text 'SELLER RWI AVAILABLE FOR'. The background of the circle shows a blurred image of a person wearing glasses and looking at a document.

SELLER RWI
AVAILABLE FOR
\$200K-\$10M
DEAL VALUE

Representations and warranties insurance market

Recent entrants, Mosaic and Risk Point, have provided welcome capacity bringing the total number of underwriting teams insuring domestic U.S. RWI to 23.

The maximum capacity for one deal is about \$750 million, with primary limits remaining around \$20–\$30 million. For deals over \$400 million, we are seeing multiple carriers on one insurance tower, including an increasing number of deals requesting excess cover for fundamental representations (with and without tax). For deals over \$1 billion, we can expect to rely on a broader range of markets than before.

Transactional risk evolution in 2021

Broader representations and warranties insurance offering for small deals

In 2021, CFC Insurance launched a product that covers seller liability for innocent misrepresentations for deals between \$200,000–\$10 million+. The average premium rate is 1.5%–3.0% of insured limit, subject to minimum costs. A large number of the deals we quoted were unaudited.

The process is designed to be less intrusive than buyer RWI. For example, no underwriting call or access to buyer due diligence is required; terms are obtained via an initial application form, often within 48 hours; and coverage can be bound within three business days following receipt of a purchase agreement and responses to underwriting questions.

Anecdotal evidence suggests that this product could allow deal parties to replace seller escrows owing to the seller being secured by A-rated insurance capital.

Insurance for fundamental (and tax) representations

Around one in five of our RWI purchasers purchased fundamental excess (or “top-up”) insurance in 2021. Rates dropped significantly in 2021, driven by competition among new entrants to this market, including Dual Asset. Rates are between 0.5%–0.9% of insured limit, and to include tax reps, it’s 1.3%–1.75%.

Intellectual property insurance

We’ve also seen growth of Intellectual Property (IP) insurance being used as a way of mitigating a seller’s exposure to rep claims. By putting in place an IP policy in the target’s name, it can provide cover for liability arising from third party IP claims that arose before signing and in the future. The target would use the IP insurance as a first source of loss mitigation before approaching the sellers.

IP insurance exists independently of the purchase agreement and RWI, potentially offering broader cover for buyers.



TAX INSURANCE
TYPICAL PREMIUM:

2%-8%

OF INSURED LIMIT



CONTINGENT
LIABILITY INSURANCE
TYPICAL PREMIUM:

5%-25%

OF INSURED LIMIT



1-2

WEEKS: MINIMUM TIME
TO PLACE RWI

Tax insurance

The tax insurance market continues to quietly grow with more underwriters being hired to tackle a broader range of risks. It is well established that RWI insurers can provide cover in the RWI policy for known tax risks, as well as structuring separate tax insurance policies where appropriate. Tax insurance is also not just for M&A; we used tax insurance to support sales, acquisitions, financing, restructurings and company liquidations.

Contingent liability insurance

We are also working with businesses that need to ring-fence known but uncertain exposures. Recent examples include litigation buy-out insurance for a claim against a target and insurance for an uncertain valuation of asset in the context of a court-ordered compulsory purchase.

Representations and warranties insurance placement process

The placement process proved challenging in the last quarter of 2021, taking an average of four working days to receive RWI indications, averaging 1-2 sets of indications on non-target sectors and 2-3 indications on favorable deals. We also noticed an increase in inquiries from buyers who were unable to obtain terms with their incumbent broker, especially for international deals.

The underwriting process has not changed, normally taking 1-2 weeks minimum to underwrite a deal from receipt of draft due diligence reports. Our recommendation is to obtain terms as early as possible (in some cases rough indications, if the buyer's draft purchase agreement is not available), then book the underwriting call shortly after engaging the insurer.

Truncated deal timelines driven by deal volume and common pinch points in the year (such as tax year-ends, public holidays and public company rules) resulted in a larger number of deals signing and incepting RWI cover with due diligence part complete. In some cases, insurers can improve cover by allowing the insured to finalize due diligence up to and sometimes beyond completion.



3.5%–4.5%

**AVERAGE RWI RATE
TO STABILISE IN
LATE 2022**

Insurance due diligence considerations for representations and warranties insurance

Our private equity and corporate clients are relying more heavily on our RWI insurance due diligence and benchmarking in order to make sure incoming targets are adequately protected at a manageable cost. Gallagher has a tailored approach for every transaction, including add-ons, new platforms, carve-outs and mergers.

For cross-border (especially trans-Atlantic) deals, we combine the experience of our local offices to accurately advise on program structuring.

With RWI limiting cover in respect of cyber, Errors & Omissions (E&O) and environmental exposure, it has become imperative to understand the interaction of existing target insurances with RWI. Through our insurance due diligence process, we are able to give underwriters comfort to avoid the need for sector-specific exclusions. In nearly all cases, we recommend our private equity and corporate clients to ensure robust cyber (and, where relevant, E&O and environmental) programs at the target level, rather than rely on representations and warranties insurance alone.

Tighter timelines have put pressure on insurance DD. Consequently, we advise that clients engage Gallagher at an early stage so we can get the right specialists engaged with time to review the data room and deliver our analysis in advance of RWI underwriting calls.

Predictions for 2022

Despite the threat of increasing interest rates, borrowing costs and new COVID-19 variants, we are prepared for purchasing demand to continue for private equity and corporate M&A.

Inevitably, there is a growing backlog of integration work for buyers in the months to come. Recent discussions with private equity houses suggest they are preparing for sale earlier in the investment lifecycle. This could divert resources away from deal doings and drive more inquiries for standalone tax and contingent risk policies, as businesses look at managing capital and ongoing portfolio risks.

Despite the record number of underwriting teams, we will need to see either a decrease in deal volume or more trained underwriters to service demand for the market to stabilize.

We anticipate a slight rate drop in the new year as the pressure of year-end signings and holidays abate. We recommend being prepared for rates to remain between 4.0%–6.0% for most sectors through the start of 2022. Towards the latter part of the year, we can expect RWI rates to stabilize for most sectors around 3.5%–4.5% into 2023. However there are going to continue to be some pinch points in sectors, such as healthcare and technology, keeping primary RWI rates above 5.0%.

We still recommend a minimum of two to three weeks to fully underwrite RWI from receipt of near-final due diligence reports (although we occasionally bind deals inside one week). We recommend booking underwriting calls in advance to manage insurers' schedules during busy times. Instructing Gallagher as early as possible during the deal process will increase the chances of gaining competitive terms and a smooth underwriting process.

Our team is there to service every step of the M&A cycle, as buying turns to integration and then preparation for sale.

Note: All statistics, unless otherwise stated, are taken from market data generated by real inquires for coverage by Gallagher clients and Gallagher's bound deal statistics.

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