

Transactional Risk 2017: Year in Review

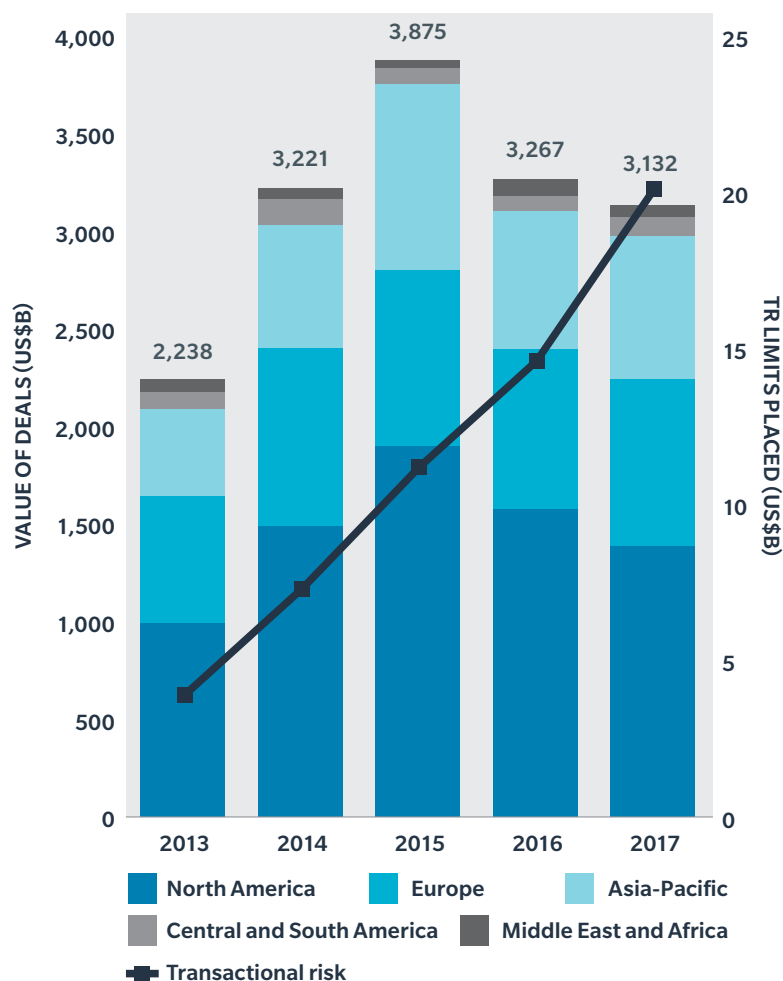
M&A Snapshot

Global mergers and acquisitions (M&A) activity remained robust in 2017, marking a third consecutive year with transaction volumes in excess of US\$3 trillion (see Figure 1).¹ Capital availability was strong — in the form of uninvested funds raised by private equity firms and robust corporate balance sheets — while the low interest rate environment continued as did the corresponding credit availability. Competition for assets by corporate and private investors somewhat reduced the number of deals closing in 2017, while simultaneously encouraging asset sales.

¹“Five M&A Trends Investors Should Watch in 2018,” Morgan Stanley, Feb. 6, 2018; <https://www.morganstanley.com/ideas/5-acquisition-trends-investors-should-watch-in-2018>

FIGURE 1 Transactional risk limits climb in 2017; M&A activity stays strong

SOURCE: M&A VALUE: Mergermarket TR INSURANCE: Marsh.



Global Transactional Risk Insurance Trends

The competitive M&A environment in 2017 led both private equity and corporate investors to increase their use of transactional risk products. In every region, 2017 saw strong growth in both aggregate limits placed and average limits placed as a percentage of enterprise value (EV).

Transactional risk insurance includes a class of policies that cover risks related to M&A, including representations and warranties (R&W) insurance or warranty and indemnity (W&I) insurance, tax indemnity insurance, and contingent liability insurance. Transactional risk insurance limits placed globally by Marsh increased by 38% from 2016, to US\$20.1 billion, due in large part to increases in average deal size and the number of transactions in which insurance was used (see Figure 2).

Also driving growth was the increased adoption of transactional risk insurance by corporate buyers. In prior years, private equity firms made the majority of purchases. In 2017, transactional risk insurance purchasers were evenly split between corporate buyers and private equity.

Overall demand for both traditional and innovative transactional risk products increased in 2017. Marsh placed more than 700 transactional risk insurance policies on behalf of clients, an increase of nearly 28% from 2016. Moreover, Marsh was asked to structure more creative applications of transactional risk solutions, including insurance to address double tax treaties, compliance with Sharia law, and Medicare/Medicaid reimbursement risks.

In response to this increase in demand, capacity in the insurance marketplace has increased meaningfully, with more than 25 insurers now offering transactional risk insurance globally. This is being driven, in part, by the desire of providers to find growth outside traditional property and casualty lines. Depending on the jurisdiction and the type of insurance product sought, more than US\$1 billion in limits can typically be available on a single transaction.

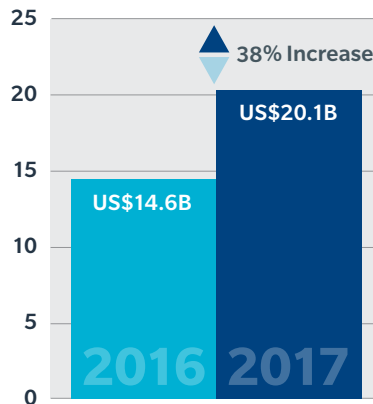
Globally, pricing for transactional risk products has continued to fall as a result of significantly increased competition in the insurer marketplace. In 2017, average pricing fell by nearly 13% from 2016, compared to a drop of about 2% in 2016 from 2015.

The following pages include data from several regions. Please note that transactional risk insurance is just beginning to enter Latin America, with both private equity and corporates binding policies and requesting quotes for new deals.

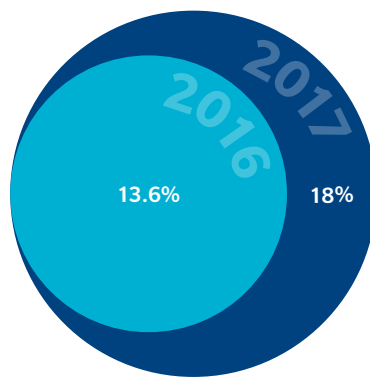
FIGURE 2 Global trends include increase in transactional risk insurance limits

SOURCE: Marsh

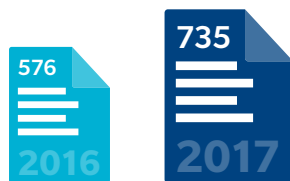
Limits placed



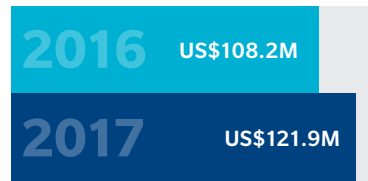
Limits placed as a % of enterprise value



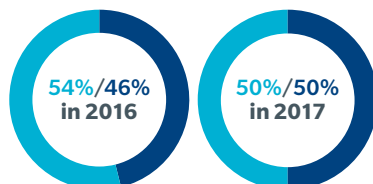
Policies placed



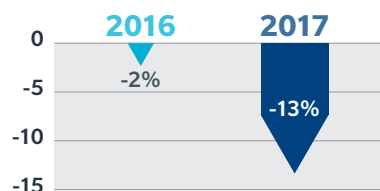
Median enterprise value



% Private Equity/Corporate



Average pricing decline year-over-year



US and Canada

In 2017, total transactional risk insurance placed by Marsh in the US and Canada grew 46% over 2016 (see Figure 3). As a percentage of enterprise value, limits in 2017 grew, to 9.5%, on average.

As in other regions, most transactional risk insurance is purchased by those on the buy-side of a deal. Buyer-side policies accounted for 98% of total policies in North America in 2017. Corporate buyers and private equity in 2017 each represented half of those purchasing transactional risk products. This continued a shift as corporate buyers were just 38% of transactional risk purchasers in 2014.

“Public-style” transactions, in which the seller has no indemnification obligation for breaches of representations and warranties, continue to increase as a percentage of transactional risk deals in the region. In 2017, 28% of deals placed by Marsh were structured on a public-style basis, up from 24% in 2016.

Deductibles traditionally have been equal to 1.5% to 2% of enterprise value for transactional risk policies in the US and Canada. Over time, these have been reduced to 1% of enterprise value on typical transactions, with large M&A transactions in the region seeing deductibles under 1%.

Pricing reductions for R&W insurance in the region accelerated in 2017, dropping an average of 13%, compared to a 4% reduction in 2016.



Europe, Middle East, and Africa

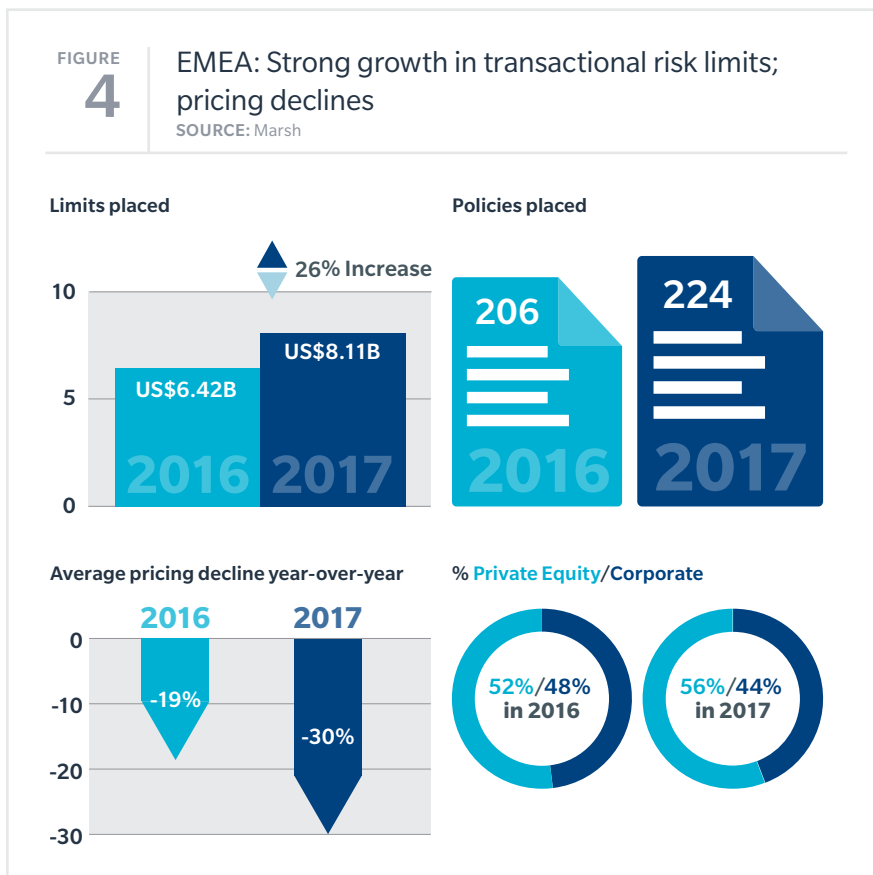
Transactional risk insurance limits as a percentage of transaction value increased in 2017 across Europe, the Middle East, and Africa (EMEA). Increased insurance capital in the M&A space in warranty and indemnity (W&I) products led to a significant reduction in pricing from 2016, with sellers seeking a low cap on liability for warranties and indemnities.

Throughout the EMEA region, “nil seller recourse” deals, in which warrantors seek to limit their liability to a nominal cap of UK£1 or EU€1, are becoming more frequent as the marketplace becomes more competitive. In 2016, about 55% of all deals in the UK offered nil recourse to the buyer, whereas in 2017 more than two-thirds of deals were nil recourse.

In addition to the purchase of more transactional risk insurance limits (see Figure 4), policy deductibles continued to shrink in 2017. Increasingly, insurers are offering deductibles below the historical norm of 1% of enterprise value, with some as low as 0.5% or even lower, in certain deals and sectors.

A growing number of insurers continue to show appetite to underwrite risk in new territories. Marsh advised on transactions covering more than 45 territories in EMEA in 2017, including in Sub-Saharan Africa.

Pricing for W&I in the EMEA region, measured by average rate on line, fell by 30% in 2017, compared with 19% in the prior year.



Asia-Pacific

Asia

The M&A market in Asia in 2017 was strong, helping propel a notable increase in the use of transactional risk insurance by both private equity and corporate players (see Figure 5).

While deal flow in China slowed in 2017 due to capital control restrictions, growth is expected in 2018, particularly for domestic deals and real estate transactions. South Korea is likely to be a growth market in 2018, as transactional risk insurance is increasingly used for domestic and cross-border deals.

The use of “sell-buy flips” has gained traction in Asia, most frequently involving private equity sellers initiating the insurance procurement process and flipping insurance to the buyer as the eventual insured. As a result, the proportion of corporate insureds grew to 63% of policies placed in 2017, up from 44% in 2016.

The traditional deductible of 1% of enterprise value fell to 0.5% or even lower in certain deals, with nil deductibles being offered for real estate transactions in first-tier cities in Asia, including Beijing, Guangzhou, Hong Kong, and Singapore. Insurers are also offering US-style enhancements in Asian policies — such as coverage for data room non-disclosure and materiality scrapes.

As more insurers have begun underwriting Asian deals, average pricing for transactional risk insurance has continued to fall, dropping 18% from 2016.



Asia-Pacific

Pacific

Significant shifts in Pacific M&A occurred in 2017. The percentage of warranty and indemnity buyers continued to veer toward corporate buyers, which represented 72% of transactional risk insurance purchasers, up from 46% in 2016 (see Figure 6). Total limits placed by Marsh jumped 20% in 2017 from 2016.

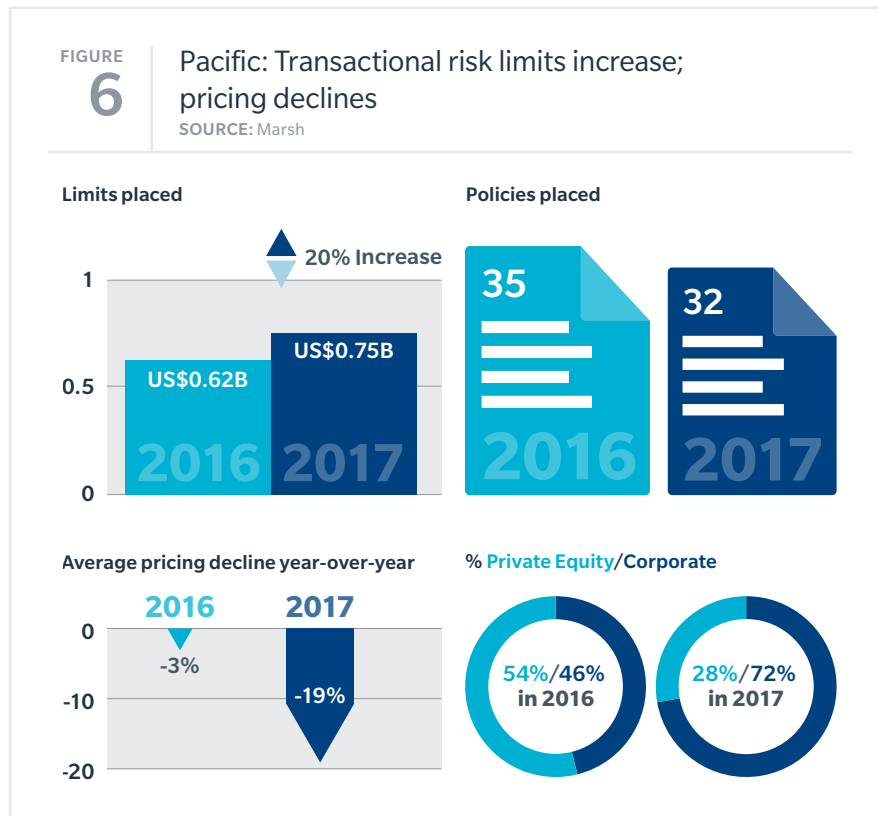
As a percentage of enterprise value, W&I limits in the Pacific region averaged 33%, up significantly from 18% in 2016. The median enterprise value in the region in 2017 was US\$37.3 million.

As elsewhere, the marketplace for transactional risk insurance in the Pacific region is competitive. Pricing has generally reduced, dropping 19% in 2017, after a 3% drop in 2016. Terms and conditions have eased at the same time, as insurers seek growth.

Deductibles are trending lower, with 1% of the enterprise value tipping to nil, and 0.5% fixed obtainable. Nil deductibles for title warranties is commonly available for limited or no additional premium, as is, subject to underwriting a *de minimis* below 0.1% of the enterprise value. “Nil seller recourse” in the sale agreement is the standard position in the Pacific.

Insurers are providing coverage for new known breaches and where appropriate will remove standard exclusions, such as transfer pricing, secondary liability, and pension transfer liability.

Notable market developments include increased interest in W&I coverage for acquisitions of listed companies and a US disclosure regime. In such deals, neither the data room nor the buyer’s due diligence report are part of the policy disclosure exclusion.



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For more information about Marsh's Private Equity and M&A Services practice, contact the colleagues below or visit our website at: marsh.com/PEMA

About Marsh

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