MARSH INSIGHTS:

TRANSACTIONAL RISK SOLUTIONS: GLOBAL UPDATE

NOVEMBER 2014

The market for warranty and indemnity (W&I) insurance has, once again, continued to show signs of growth in the first half of 2014, both in terms of the number of policies placed and limits of insurance purchased.

In the first half of 2014, Marsh's global specialist teams placed a total of USD3.5 billion in insured limits, representing a 59% increase in insurance limits placed over the same period in 2013. The growing awareness among the deal community, or those companies involved in mergers and acquisitions (M&As), of the opportunities created by W&I risk solutions has driven demand for the product in jurisdictions where take-up rates have historically been low. (See the "Spotlight" column on page 2 for a more in-depth look at this trend.)

Driven, in part, by an increase in deal value and the limits of insurance purchased, the US and Canada showed the greatest growth in the purchase of W&I insurance, with a 225% increase in the limits of insurance placed.

The motivations for using W&I insurance differ depending on whether a company is on the sell side or buy side. On the sell side, key motivations include the reluctance to retain proceeds in escrow and the ability to achieve a "clean exit". On the buy side, creating strategic value during an auction process, concerns about the strength of a seller's financial covenant, and mitigating jurisdictional specific risk on cross-border transactions are all primary concerns.

The issues we discuss in this edition include:

- The growth of W&I placements in the Germanic region.
- The placement of the first W&I insurance policy in the Philippines.
- Claims trends in the W&I insurance market.

US

- In the US market, private equity sellers have been driving bidders in auctions to accept buyer-side W&I insurance, in lieu of a traditional escrow, to achieve a cleaner exit.
- Marsh teams in the US continue to see an increase in the use of W&I insurance on transactions greater than USD500 million in enterprise value.

TRANSACTIONAL RISK GLOBAL STATISTICS H1 2014

	EMEA*	ASIA-PACIFIC	US AND CANADA	TOTAL
Limits of insurance placed (USD millions).	1,988	286	1,245	**3,519**
Number of transactional risk policies placed.	73	14	53	**140**
Private equity policies placed (as % of policies placed).	52%	57%	74%	**61%**
Corporate policies (as % of policies placed).	48%	43%	26%	**39%**
Seller-side W&I policies (as % of W&I policies placed).	14%	7%	24%	**17%**
Buyer-side W&I policies (as % of W&I policies placed).	86%	93%	76%	**83%**

*Europe, the Middle East, and Africa

SPOTLIGHT: INCREASED TRANSACTIONAL RISK ACTIVITY IN THE GERMANIC REGION

The transactional risk insurance market has historically been relatively slow to take off in German-speaking jurisdictions, due to a mixture of unfamiliarity and scepticism among the deal community. However, since January 2013, Marsh has witnessed phenomenal growth in the placement of warranty and indemnity (W&I) insurance policies in Austria, Germany, and Switzerland (collectively known as the Germanic region), as well as an increase in the degree of comfort and familiarity companies are displaying toward this "deal tool". The first half of 2014 has been particularly busy for Germanic-region W&I placements, with the Marsh team having already placed more policies in this region than it did during all of 2013. The majority of W&I polices placed for Germanic region transactions have been buyer-side policies. As a result, buyers are using W&I insurance strategically to differentiate their bids, which affords a lower cap on the liability retained by the sellers. In view of this, a buyer-side W&I policy is often structured above this lower cap amount in order to give the buyer the leverage it requires to gain board or investment committee sign-off for the deal.

EMEA

- Marsh's transactional risk specialists in EMEA structured insurance for targets in a wide range of jurisdictions in the first half of 2014, including Poland, South Africa, the Czech Republic, and Finland.

Emerging trends for Germanic-region transactions include seller-initiated buyer policies that have flourished in jurisdictions such as the UK, as well as seller-side policies that enable sellers to free up capital for new acquisitions.

The W&I market in Europe, the Middle East, and Africa (EMEA) has responded to this growth in Germanic-region W&I placements by increasing the pool of underwriters that focus on this area. Currently, there are three native speaking German underwriters, in addition to a number of other insurers that have the ability to underwrite German-language deals. Marsh's transactional risk team is also heavily investing in its German practice, and now has two German brokers who service Germanic-region deals.

PACIFIC REGION

- There is an increasing prevalence among corporations involved in cross-border transactions to use W&I insurance solutions when making acquisitions in the Pacific region.
- In the Pacific region, there is a clear bias towards limited or no-recourse deals. This is being driven by a desire among sellers to achieve a "clean exit", as specified in the terms of the sale and purchase agreement, with W&I insurance being a buyer's only recourse.

SINGAPORE

- Marsh's Singapore team has seen a dramatic increase in the use and awareness of W&I insurance in 2014.
- Private equity firms continue to be the biggest buyers of W&I insurance in Singapore.

CASE STUDY

Marsh's Transactional Risk Team Completes the First W&I Insurance Placement in the Philippines

A global infrastructure fund headquartered in the US was seeking to acquire a Philippines-based oil storage terminal company. As is common in cross-border transactions, the buyer was not familiar with the local legal and regulatory climate, and was also concerned about the strength of the seller's covenant. Unwilling to proceed with the transaction in the face of such concerns, the buyer approached Marsh looking for a way to allocate the warranty risk in order to facilitate the transaction. Marsh introduced the concept of W&I insurance as a risk mitigation tool.

Although the use of W&I insurance as a means of facilitating transactions such as these is not a new one, the challenge was that there was only one insurer with the appetite and authorisation to underwrite a transaction in the region, and that it had yet to do so successfully. Adding to the challenge was the client's environmental exposure and the extensive set of environmental warranties that the buyer was looking to have insured. Moreover, the limited market appetite for such a risk was further complicated by the fact that the buyer had undertaken only limited environmental due diligence.

However, working closely with the client and insurer, the Marsh team facilitated and participated in several rounds of discussions, which enabled the insurer to get comfortable with the exposure and eventually underwrite the risk.

As the growth in demand for transactional risk solutions increases, insurers in the Asia-Pacific region can be expected to deploy more capital as they compete to underwrite risks.

CLAIMS

Claim notifications under W&I insurance policies are on the rise, resulting in significant settlement payments being made by insurers.

The amount of breach of warranty claims that are related to accounts and financial statement warranties is increasing. The claims that Marsh currently manages, as well as those that are currently in the W&I insurance market, range from amounts that would be unlikely to exceed the aggregate claims limit (or retention under the policy) to amounts as high as the full transaction value. Although, in the past, the occurrence of warranty claim breaches was low, an increase in claim notifications and paid insurance claims for breaches of warranties in private market mergers and acquisitions is inevitable as the number of policies written continues to grow.

The increase in the number of claims being made by insureds and settled by insurers is a testament to the utility of W&I insurance.

FURTHER INFORMATION

Marsh's Private Equity and Mergers & Acquisitions Services Practice recently hosted two webinars that covered various transactional risk topics.

- The first webcast, *Managing Transactional Risk: A 101 Class,* covered the following topics:
  - Representations and warranties.
  - Tax and indemnity insurance.
  - Contingent liability insurance.
  - Environmental insurance.
  - Environmental liability buyouts.
- The second webcast, *Managing Transactional Risk: How to Use Insurance Capital to Solve Deal Issues,* covered the following topics:
  - Contingent liability insurance.
  - Political risk insurance for private equity investments in emerging markets.
  - Non-payment coverage for commercial contracts or debt transactions.
  - Key life and disability policies.

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