MARSH

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Mergers and Acquisitions Insurance Update: Pacific

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Introduction

Warranties and indemnities (W&I) insurance is playing an increasingly important role in the successful completion of mergers and acquisitions (M&A) transactions across the Pacific region. In a mature and highly competitive market, both buyers and sellers know the benefits offered by W&I insurance, and are focused on pushing the level of coverage being offered.

The *Pacific Mergers and Acquisitions Insurance Update* identifies a number of significant trends in the W&I market based on the transactions Marsh closed in 2017 including:

- A growing demand for greater coverage limits
- Historically low W&I insurance premium rates
- Sellers increased use of W&I insurance in competitive auction processes

The report provides an update on the key W&I insurance metrics in order to offer a nuanced picture of coverage outcomes possible in the W&I insurance market along with some predictions on future W&I insurance trends and product features.

This report will aid buyers, sellers and deal advisors in navigating the current state of the market, and how to best utilise the product given market conditions.

FIGURE 1

Pacific M&A insurance trends

SOURCE: MARSH DATA

Drop in premium

Pricing has decreased from 1.20% to 0.97% as rate on line (premium as a % of limit purchased)

Increase in limits

From 2016 to 2017, there was a 20% growth in limits placed

Premium rates in decline for domestic transaction

Premium rates continued to come down, fueled by greater amounts of insurance capital and increased competition between insurers.

Throughout 2017, there was a high level of competition between underwriters to win Australian deals. The Australian M&A market is viewed positively due to its maturity, sophistication, and well developed rule of law. The average rate on line for domestic M&A deals with a retention rate of 1% fixed was at 1% for targets valued at $80 to $150 million.

For transactions with insured limits greater than $400 million, the average rate on-line was below 1% where excess insurance layers were provided, as the risk is spread across multiple insurers and the blended rate is lower as a result. The primary layer however would be priced nearer a rate on-line of 2%.

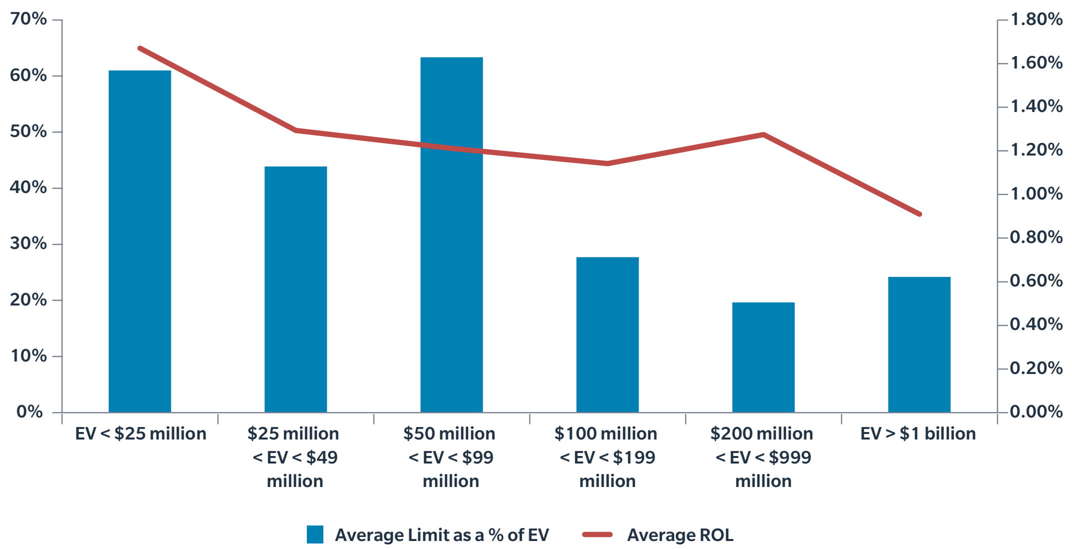
While insurers competed to provide W&I cover for mid- to high-value transactions, ensuring lower average rates for such transactions, the pricing was less competitive for deals involving transactions worth less than $25 million due to the minimum premiums charged by some insurers. In order to assist with these transactions, Marsh's Private Equity and Mergers and Acquisitions ("PEMA") team, with input from insurers, is developing a standardised W&I insurance offering with a simplified underwriting process to serve this growing W&I insurance segment.

New entrants have bolstered competition in the W&I market, encouraging established providers to consider alternative options on how to distinguish themselves and to provide innovative coverage.

FIGURE 2

Average limit as a percentage of enterprise value (EV) and average ROL by enterprise value range

SOURCE: MARSH DATA



INSURERS' RISK SECTOR PERCEPTIONS

While premium rates continued to decline for more straightforward domestic transactions, higher rates were applied by W&I insurers on more complex deals, for example those involving a target with operations in multiple jurisdictions, those involving a cross-border element, or for transactions in sectors where insurers have seen high levels of claims in the past.

Traditionally, insurers have viewed deals involving businesses in the financial services, natural resources and constructions sectors, as higher risk, due to both the high level of compliance and regulations as well as the nature of these businesses and operations. There are a number of inherent factors and risks that insurers consider when providing W&I cover in these industries, as claims can be significant should they arise.

W&I insurance played a key role in facilitating the purchase of an Indonesian mine by an Australian resources company, as it provided the buyer with a means of protecting its purchase price.

However, due to the location of the target and the nature of the business being acquired insurers viewed it as "high risk", which was reflected in the higher than average premium.

Increasing focus on coverage

With competitive premium rates being offered for many deals, buyers and sellers in the Pacific region are looking to maximise the coverage and benefits they can obtain through W&I insurance.

In 2017 the average coverage limit purchased reached 33% of the enterprise value, up from 18% in 2016, as clients developed a greater understanding of the value of W&I products.

As clients have become more experienced in using W&I products they are keen to discuss deal-specific exclusions and warranty carve-outs before selecting an insurer.

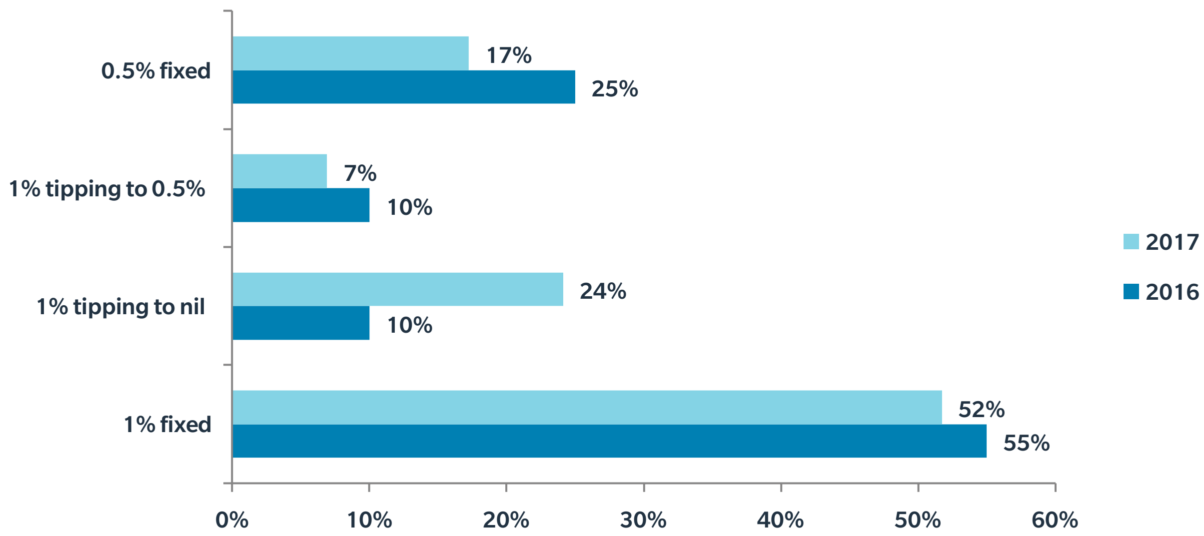
Throughout the year buyers also expressed a preference for lower de *minimis* and policy retentions, and were willing to pay additional premium to lower these financial thresholds. In 2017, one-in-four transactions utilised a retention rate of 1% tipping to nil, compared to one-in-10 the previous year.

Requests for lower de *minimis* are likely to become more frequent as more buyers are becoming more familiar with W&I policy terms being offered outside Australia, particularly in North America, where zero de *minimis* is a key feature of such policies. It is already the norm for a nil de *minimis* and retention to be offered on title and capacity warranties, and for true property transactions.

FIGURE 3

Retention options breakdown by percentage of policies

SOURCE: MARSH DATA



REFERENCE CHECK

Some clients prioritise insurers' reputations for claims handling when selecting between insurers, seeking references from lawyers, accountants and previous clients before making their selection.

This was particularly prevalent among those who had not used W&I insurance before or were not familiar with some of the more boutique insurers, and wanted reassurance that the claims process would be smooth in the event of a breach of warranty and potential claim.

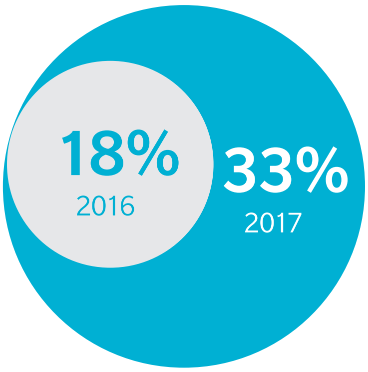
For some clients the focus on reputation extended beyond the quality of claims handling by the insurer's W&I team, opting to use a big name, with a strong reputation for claims handling across its insurance lines.

One recent transaction Marsh's PEMA team worked on involved a Japanese buyer and an Australian target, the desire to secure lower retention rates saw the client select the most expensive market as only the chosen insurer was able to offer a tipping to nil retention. This was symptomatic of how clients are increasingly looking at having more flexible retention options and coverage enhancements to the detriment of premiums.

FIGURE 4

Limits placed as a percentage of enterprise value

SOURCE: MARSH DATA



Amount of limit purchased has almost doubled from an average of 18% to 33% as a percentage of the enterprise value

NEW M&A INSURANCE PRODUCT WAVE

Competition between insurers and clients' desire for greater coverage through W&I insurance has also driven product innovation and the emergence of hybrid policies.

New non-Australian insurers entered the Australian market in 2017, bringing a suite of innovative solutions - including title insurance products for real estate and shares, and contingent liability - in order to fill the gaps in coverage for specific issues (such as environmental risk) that are relevant from a risk mitigation perspective.

These new products combined with the current competitive market are likely to drive further innovation from the more established W&I insurers.

STREAMLINING THE UNDERWRITING PROCESS

Some clients perceive that the W&I underwriting processes can be challenging and time consuming. The main challenge is often responding to all the questions insurers ask during the process.

The ease of use can also be a deciding factor for clients when purchasing a W&I policy.

Frequently insurers will issue two tranches of questions, one covering general topics, followed by a deal specific questionnaire prior to an underwriting call between the insurer, client and their advisors.

Throughout 2017 the PEMA team continued to work with clients to streamline the process by:

- Reasonably limiting the number of underwriting questions posed
- Ensuring the responses provided by the client are thorough, thereby limiting the time spent on the underwriting call by all the advisors
- Setting up a pre-underwriting call with the client and its advisors, so they are fully prepared for the final underwriting call
- Eliminating the need for an underwriting call in cases where the diligence and underwriting responses are comprehensive and the client is a regular user of W&I insurance

M&A insurance trends

WHO IS BUYING?

In 2017 there was an increase in the number of sellers opting to run competitive auction processes, which resulted in a rise in the number of sellers who required bidders to hold W&I insurance as part of their bids.

This attracted more strategic bidders looking to purchase competitors, or to expand or diversify their businesses through acquisitions, than in previous years, which in turn led to an increase in their use of W&I insurance.

Strategic buyers accounted for two-thirds of W&I policies Marsh placed, while the remaining 28% of policies were purchased by financial buyers (private equity or institutional investors).

COMPETITIVE AUCTION PROCESSES

In many of these auctions the sellers engaged with Marsh's PEMA team to commence and advance the W&I process with the insurers, developing a close-to-final policy that was then flipped to the preferred bidder for confirmatory underwriting after the final bid date.

However, some auction processes required bidders to negotiate their own close-to-final W&I insurance before final bid dates.

This enabled bidders to obtain expanded cover and establish a key point of difference in their bid, whilst permitting the seller to achieve a clean exit and ensuring the bidder was adequately protected, regularly in excess of the terms of maximum liability under the acquisition agreement.

In a number of these cases Marsh's PEMA team assisted multiple bidders, by splitting into confidential streams, and directing W&I insurers to do likewise, to develop W&I policies for the individual bidders' needs, while enabling the seller to continue to run a competitive process.

DISCLOSURE

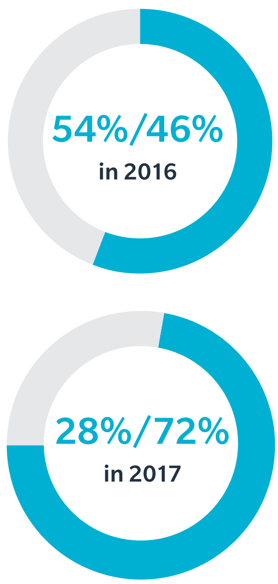
With the increased number of competitive auction processes involving multiple bidders the use of "black box" set-ups has become a regular feature of data rooms.

While important information that W&I insurers ultimately need to see before issuing a final policy may be stored in the black box, the Marsh PEMA team has not encountered issues with the W&I process as a result of the black box information being released later in the process.

Most W&I insurers are prepared for this scenario, and they expect to review the updated due diligence undertaken by the legal, financial and tax advisors of the selected bidder therefore the presence of a black box will generally not engender any delay in the finalisation of the W&I insurance.

As part of one transaction that was completed in 2017, Marsh's PEMA team worked with the seller and underwriter to establish a W&I policy before engaging with three bidders. The team and the insurer created three confidential teams to work with each bidder prior to the final bid date, therefore enabling the bidders to present a fully negotiated and underwritten policy with their sale and purchase agreement and with full confidence that the warranties were covered.

FIGURE 5
PE vs Corporate buyers
SOURCE: MARSH DATA



Marsh's PEMA team assisted with one such transaction where a listed seller was disposing of the majority of its assets. The seller was in a financially volatile position and it needed to return any sale proceeds as efficiently as possible to the shareholders.

W&I insurance assisted the transaction by providing a recourse structure that suited the buyers and the seller. The actual underwriting requirements were no different to a private deal.

To date, in the Pacific region, the insureds' due diligence reports are included in the definition of Disclosure Materials for the purpose of the W&I policy and therefore captured by the Disclosure exclusion. However the insurers are starting to consider the option of removing the due diligence reports from the definition of Disclosure Materials for an additional premium.

TIMEFRAMES

In 2017 the Marsh PEMA team adapted the W&I process and was able to accommodate a variety of timetables, particularly for clients with experience using W&I insurance. Whilst the ideal timetable for the placement of a W&I policy remains at 3 weeks, the process can be expedited.

In auction processes, many W&I insurers were able to work with bidders to ensure the underwriting process was ready to complete prior to the seller awarding exclusivity, which enabled transactions to be completed within the timeframes set out.

PUBLIC DEALS

In 2017 there were a number of transactions involving publicly listed entities, and W&I insurance had a critical role in ensuring the deals went through.

CARVE OUT

In cases when a public company was selling a subsidiary, the W&I insurance process continued to be relatively straightforward, and the policies were handled in the same way as private transactions were, particularly when clients met the following criteria:

- Full disclosure with a customary data room and Q&A process
- Due diligence reports for legal, finance and tax matters
- Arm's length negotiations especially in regard to the warranties
- Ensure that personnel who have the requisite knowledge and understanding of the target group have been involved in the sale process accordingly

DE-LISTING

While W&I insurers have treated deals involving the sale of a subsidiary, or part of a listed entity, in a straightforward manner, transactions that lead to a delisting of the entity have been viewed as being more complicated, as it is not often clear who (if anyone) is giving the warranties.

One of the challenges to employing W&I insurance for a deal involving a public target is that the structure of the shareholdings means that none of the public shareholders are in a position, or willing, to provide a meaningful set of warranties. This can be overcome in some cases if there is a major shareholder and/or management giving the warranties, alternatively it remains with the target giving the warranties.

As always the W&I insurers require that the buyer commission legal, financial and tax due diligence as a minimum and that the sellers maintain a well-populated data room which serves to qualify the warranties.

In some cases W&I insurers require that there is a solvent entity/person that they could subrogate against in the event of fraud. However, it is a misconception that W&I insurers require warrantors to retain liability in order for public transactions to be insurable. Rather, so long as the other conditions are met (a well-populated data room, commercially appropriate due diligence, and a reasonable and negotiated set of warranties), W&I insurers generally are willing to offer W&I on a nil recourse basis.

In 2017 there were a number of transactions involving publicly listed entities, and W&I insurance had a critical role in ensuring the deals went through.

On a recent cross-border transaction the collaboration with our Marsh PEMA colleagues overseas was invaluable as their understanding of the local insurance compliance framework allowed the client to have a valid and binding insurance policy within only few days.

The combination of market experience in the different Marsh teams also enhanced the overall coverage terms and, depending on the time zones involved, can provide a 24-hour service.

CROSS-BORDER TRANSACTIONS

According to 'Mergermarket Trend report for Australia (Q1-Q4 2017)', inbound M&A activity was valued at $80.5 billion last year, up by 141.5% compared to previous year, and represented 71% of the overall Australian M&A value.

The cross-border M&A activity in Australia was reflected in an exceptional number of enquiries on W&I insurance.

In 2017 Marsh saw a 10% increase in the number of W&I opportunities generated from cross-border transactions involving both Australian inbound and outbound investments. More than a third of Marsh's W&I insurance placements in 2017 had a cross-border component and W&I insurance was chosen by parties and advisors involved in the transaction as a risk mitigating tool in transactions where a party to the transaction was not familiar with the target's jurisdiction, tax and legal framework and overall risk exposure.

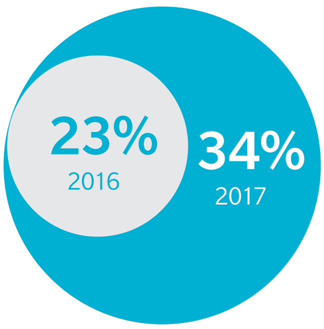
When seeking W&I insurance to cover cross-border transactions buyers and sellers will need to carefully consider the following elements:

- Who will be the insured?
- Jurisdiction/Acquisition agreement governing law
- Different compliance requirements for the policies
- Taxes payable
- Different requirements for premium payment
- Disclosure processes

FIGURE 6

Growth in cross-border transactions

SOURCE: MARSH DATA



Deals involving cross-border transactions has increased form 23% to 34%

Market forecasts

In 2018 Marsh has already seen and expects to see a continued increase in the use of W&I insurance policies in competitive auction processes involving large deals where the transaction process's sophistication will make W&I insurance a key contributor to the seller's negotiations with the bidders.

We also anticipate that:

- Competition between W&I Insurers will be increasingly focused on coverage rather than pricing and Marsh expects to see lower retention and de minimis options being sought by insureds.
- Growth in the use of multiple W&I underwriting streams in auction processes as a way to enhance the overall bid and keep competition tension between the bidders.
- More W&I placements involving publicly listed companies as brokers explore these placements with a broader panel of W&I insurers.
- In a market dominated by low premiums, more W&I Insurers will be offering hybrid W&I products, coverage for specific indemnities and changes in material disclosed in order to secure additional W&I premium streams.

Conclusion

In 2017, Marsh achieved improved coverage for our clients at cost-effective premium rates, facilitated by competition between W&I insurers.

W&I cover has proved itself to be a strategic tool for both sellers (mandating its use in auctions) and buyers looking to secure improved warranties, liability structure and consequent risk allocation before completing a transaction, thereby eliminating potential stumbling blocks in negotiations.

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