MERGERS & ACQUISITIONS INSURANCE MARKET INSIGHTS 2020

OVERVIEW - YEAR TO DATE

Insurance capital remains a critical tool for dealmakers to de-risk and facilitate deals, particularly where the transaction involves sellers or target businesses that are in distress.

- Deal flow for Q1 of 2020 started well off the back of strong momentum from the end of a busy 2019. However, the fallout from the burgeoning impact of COVID-19 and public market sell-off in February and March tempered a number of transactions, with fewer new deals coming to market and existing deals slowing down.
- With lockdown measures easing across Australia and New Zealand, we are hopeful M&A activity will increase in the last quarter of the year as markets recover. Infrastructure and health-related transactions have stood up well during the year, and we expect this trend to continue.
- PE firms still have considerable capital to deploy, but to date their attention has been focused on their portfolio companies and the aftermath of COVID-19. Now, we expect PE firms to be enticed back into the market, especially if distressed assets are available for sale at cheaper prices.
- PE firms will also be looking for value in take private transactions where the current market capitalisation of a listed company continues to be significantly lower than its pre-COVID-19 peak.
- Insurance capital provides a critical tool to de-risk and facilitate deals, including where the target is in distress. Through the employment of W&I solutions sellers can attract stronger interest in their assets by offering bidders a customary suite of warranties and indemnities. Buyers can gain comfort from having access to secure insurance capital and greater flexibility around structure and scope of the warranty package than would be typical on a distressed deal. In particular, we see real value in administrators running an administrator-led warranty and indemnity insurance process, so a buyer can receive meaningful protection if it chooses to acquire an asset or target out of administration.
- The number of insurers in the Asia-Pacific market continues to increase, with insurers able to inject more insurance capital on deals, driving competition. With fewer deals coming to market this year, we expect prices and coverage terms to remain competitive especially in the excess insurance markets.

IMPACT OF COVID-19 ON THE WARRANTY AND INDEMNITY INSURANCE MARKET

Most insurers responded initially to the pandemic by mandating some form of COVID-19 exclusion into a W&I policy. However, we've seen a swift movement away from this as we ask insurers to underwrite to the risks, and fewer policies are now including such an exclusion.

COVID-19 has forced insurers to focus their attention on:

- **Financial performance** - Insurers are paying closer attention to the recent financial performance and day-to-day trading of the target business, particularly those in vulnerable sectors like tourism and retail, or SMEs. Insurers are closely looking at financial results to understand the full impact of the lockdown and how solvency warranties, in particular, are impacted specifically once financial stimulus ceases.
- **Valuation and multiples** - Insurers are also looking closely at the valuation of businesses in this environment to ensure the pricing multiple makes sense considering the revenue outlook. The multiple here is important as it may be used to quantify the total loss of a buyer.
- **Employment** - Insurers are keen to understand whether companies have received any wage subsidy or JobSeeker allowance. Two issues will be pertinent: was the target eligible to receive the allowance?; and was the correct amount received? On a related topic, given widespread enforced pay reductions across all industries, insurers want to make sure these were made in compliance with employment law.
- **Material contracts** - Insurers are looking very closely at material contracts, especially those with a cross border element. Insurers want to confirm whether the buyer has assessed the material contracts to determine termination rights that may be exercised because of the COVID-19 situation.
- **Compliance with laws** - Showing compliance with new legislation introduced due to COVID-19 from a legal and tax perspective will be important. We recommend that diligence reports specifically address COVID-19 impacts from a regulatory perspective to avoid any broad COVID-19 exclusions from insurers.

Insurers assessing a business through the lens of the pandemic will need to contemplate the potential tax, financial and legal impacts of COVID-19. We recommend carrying out diligence directly in respect of COVID-19, which may help negate the need for any COVID-19 exclusion in the W&I policies.

Impact of COVID-19 on the offering of New Known Breach Cover

Insurers will look carefully at terms for offering New Known Breach Cover. This is cover for breaches of warranties that first occur and are discovered by the buyer after signing but before completion. Some insurers are reluctant to offer this enhancement to cover due to the current volatility and longer interim periods. However, we see this as being an evolving issue, with scope for this offering to be subject to competition at the marketing phase of a transaction whilst there is negotiating tension.

UNDERWRITING FOCUS AREAS AND WARRANTIES OF CONCERN

Employment

Insurers are closely scrutinising employment related matters in M&A deals. This scrutiny follows large organisations caught up publicly in "wage theft" scandals involving underpaying employee entitlements including superannuation.

Insurers expect reviews of a representative sample of employees (5% to 10% of permanent and casual employees) for confirmation of compliance with employment awards and enterprise agreements. Cover for NZ holiday pay will also require strong due diligence to confirm compliance, including sample testing the workforce.

With increased regulatory scrutiny on criminalising worker exploitation, we expect insurers to continue to pay close attention to this area.

Cyber risks

Cyber-related matters are emerging as one of the key points of consideration in an M&A transaction. This concern is further exacerbated as the trend in recent data[1] shows ransomware attacks increased significantly during the COVID-19 crisis.

Based on Aon's 2019 Global Risk Management Survey, cyber attacks and data breaches are currently one of the top 10 risks concerning organisations and this has steadily grown over the past four years. A recent survey conducted by Deloitte noted that 53% of respondents had encountered a critical cyber security issue that put an M&A transaction at risk, with 70% of respondents viewing protection of data assets in a company being acquired or divested as a primary concern[2].

As global scrutiny of data handling and cyber risks continues to be at the forefront, insurers are paying attention to this area. Insurers will look to understand the procedures and processes in place to mitigate data security breaches. Our specialist cyber consultants can help to assess critical cyber risks and vulnerabilities and evaluate a target's security posture and preparedness against key threats.

Remediation of contamination

While W&I insurance covers compliance with environmental laws, the policy does not cover the remediation of contamination exposures (either as an owner or operator), regardless of the due diligence undertaken. Insurers take the view that such exposures are more appropriately covered under an environmental liability insurance.

Our environmental liability specialists can arrange to structure environmental insurance to overlay with the W&I policy to protect seller and/or buyers against the financial impact of unknown pollution that pre-dates the transaction, i.e. pre-existing or legacy pollution.

In addition to insuring legacy pollution risks, we can arrange to structure cover for ongoing operational risks resulting from pollution that commences on or after the date of the transaction, i.e. that is new pollution. This extension is useful for buyers who will have ongoing pollution exposures. We regularly work with insurers to customise environmental insurance programs on M&A transactions to the characteristics of a transaction and the specific needs of the deal.

Product liability and professional indemnity

Similar to environmental liabilities, W&I insurers take the view that professional services and product liability exposures are more appropriately covered under professional indemnity and product liability insurance cover.

Greater scrutiny is applied by insurers around such exposures in transactions recently, particularly in targets involving the provision of professional services and the manufacturing and development of products. We seek to ensure insurers underwrite to such risk on a deal-by-deal basis and limit any potential coverage issues to the relevant services and product offerings of the target.

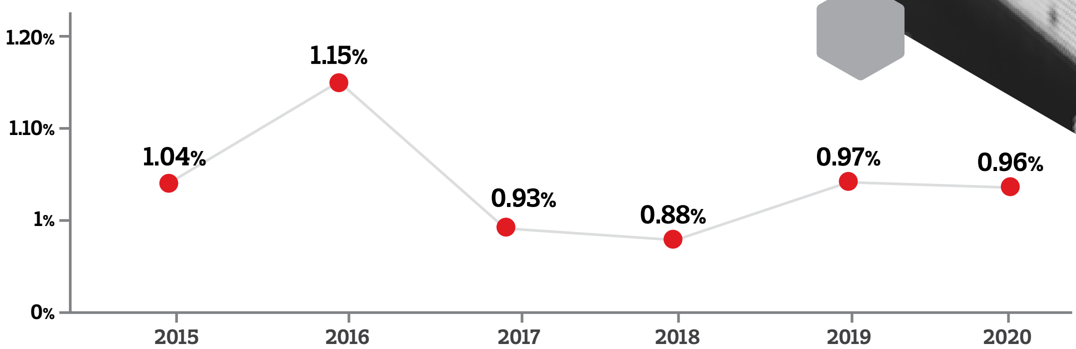
Our M&A insurance due diligence team can identify risks associated with the target company's existing insurance program to ensure optimal structuring of insurance programs going forward. This helps clients to understand how the assets and earnings of the target company were protected historically and ensure we adopt best practice going forward.

[1] https://www.who.int/news-room/detail/23-04-2020-who-reports-fivefold-increase-in-cyber-attacks-urges-vigilance; https://www.canberratimes.com.au/story/6786092/pandemic-has-increased-cyber-security-risks-for-government-and-businesses/

[2] https://www2.deloitte.com/content/dam/Deloitte/us/Documents/mergers-acqisitions/us-mna-trends-2020-report.pdf

Our specialist advice also highlights future insurance cost (or potential savings) that can impact financial models and price negotiations. Our M&A insurance due diligence team also undertakes vendor insurance due diligence, assisting the vendor to maintain control over the sale process and the release of information to potential bidders.

WARRANTY AND INDEMNITY INSURANCE METRICS IN 2020



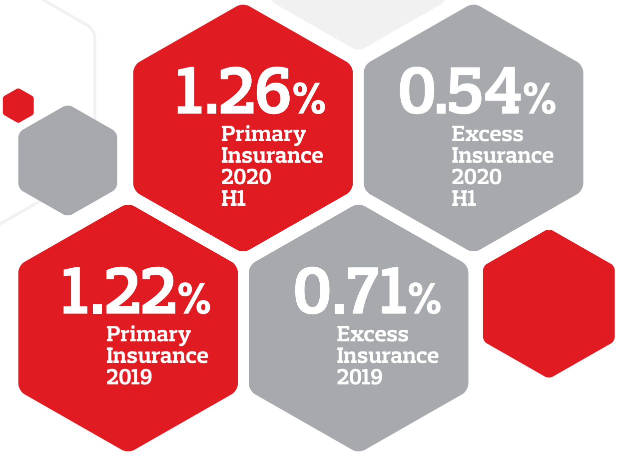
Source: Aon proprietary data

Despite the impact of COVID-19 on coverage as detailed above, in H1 2020 a buyer's market emerged with a number of 'client friendly' market trends from previous years, including:

- Insurers are comfortable deploying larger amounts of capital on any one transaction subject to appropriate capital ventilation.
- Primary insurance rates (pricing for the first layer of loss above the retention, i.e. deductible) remain low and steady.
- Average premium rates in 2020 continue to be below 1% of the limit insured.
- W&I insurers are willing to offer enhancements to help buyers and sellers protect themselves against transactional risks. These enhancements provide better coverage than sellers would typically be willing to offer under a negotiated package, such as lower de minimis (or per claims threshold), flexible retention options and longer policy periods.
- Inbound deals from the US also increased, leading to more US-style policy enhancements through the latter half of 2019 and into H1 2020.

Average premium rates

Larger deal sizes in 2020 pushed the average primary insurance premiums up from 2019 but given the larger insurance towers being built, this has also meant the average excess premiums have come down from 2019 as buyers are buying greater limits of liability.



Retention/deductible trends

Insurers are continuing to offer tipping or lower retentions on transactions[3], with clients seeing the benefits and electing retentions below the standard 1% of enterprise value. We are also seeing insurers offer a 0.05% of enterprise value de minimis option where the due diligence supports this.

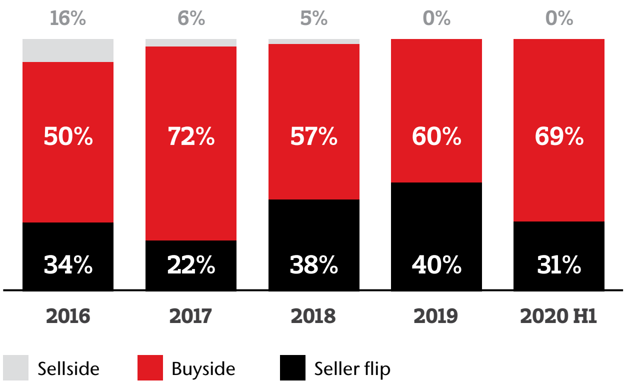
2019 – 0.61%

2020 H1 – 0.53%

Average retention amount as a % of purchase price has decreased in the last year

Source: Aon proprietary data

More attractive retention structures are also being offered and taken up by purchasers as the price for these structures continues to come down in both jurisdictions.



Source: Aon proprietary data

Over time, across Asia, Australia and New Zealand the majority of policies are placed on the buy side.

The duration of policy periods is quite similar across Asia and Australia.

Policy periods have remained consistent for 2020.

- Title and tax warranties and tax indemnity – 7 years
- General/operational warranties – 3 years

AON BROKING INNOVATION PROVIDES DISTINCT ADVANTAGE

Offered exclusively to our clients, Aon Client Treaty (ACT) is a broking innovation enabling eligible Aon clients to automatically access 15% of dedicated Lloyd's of London co-insurance capacity attaching to underlying placements. This additional 15% capacity is guaranteed on a follow-form coverage basis.

Ideal for large or complex placements, it offers our clients efficient pricing with market-leading coverage, making available the largest amount of W&I insurance capacity of any broker in the Australasian market place.

[3] Standard retention levels on W&I policies is 1% of enterprise value of the target. Tipping retentions refer to retentions that tip to a lower amount once the retention is satisfied (e.g., a retention which tips to $500,000 once $1m of loss has been incurred on a $100m transaction, meaning that the buyer can recover loss in excess of $500,000 from the insurer). Lower fixed retentions refer to retentions which are lower than 1% of enterprise value but do not have a tipping feature such that they reduce to a lower amount once satisfied.

LOOKING AHEAD – TRENDS FOR Q4 2020 AND BEYOND

- Distressed deals are likely to feature more in Q4 2020 and beyond as sectors such as retail, tourism and hospitality continue to struggle in the pandemic. This will likely increase demand in insurance products such as synthetic warranties.
- The demand for US-style W&I insurance coverage continues to grow as US inbound activity increases. We have seen insurers price aggressively for US-style cover in Australia. Sellers and buyers are becoming more sophisticated with the US disclosures and diligence process leading to pricing efficiency.
- We expect the demand for W&I in public to private transactions to increase as PE will look for undervalued companies as public markets continue to be volatile in the pandemic. W&I insurance gives buyers the benefit of fulsome warranties which would not otherwise be received from public company shareholders.
- A resurgence of private investments in public equity (PIPE) transactions in the US will likely be mirrored in Australasia as private equity firms seek to deploy their capital to secure sizable stakes in increasingly cash-strapped public companies at attractive valuations.
- Sectors such as medical, allied health, technology, renewable energy and agriculture continue to be attractive sectors for buyers in 2020 and we have seen a resurgence of insured deals in these sectors lately. This is expected to continue as corporates and PE are likely to look for businesses insulated by the pandemic.
- We also expect to see consolidation in industries such as financial services and aged care on the back of their respective royal commissions. 2020 has already witnessed notable financial services transactions, particularly with the big banks divesting large sections of their wealth and superannuation businesses. We expect to see some consolidation in the aged care sector as the pandemic clears.
- We expect there will be increased M&A activity in the commercial RE sector as businesses think differently about their physical office space requirements going forward. The industry is also becoming more sophisticated in using W&I insurance and understands the benefits to investment returns by eliminating lengthy escrow and hold back structures.

TAX, LITIGATION AND INTELLECTUAL PROPERTY RISKS

Strategic uses for our insurance solutions such as tax and litigation risks continue to rise. We have seen many insurers bolster their own ranks with bringing on specialist tax expertise. We expect tax and litigation solutions to play a big role in distressed M&A and corporate transactions in the coming months. Both tax and litigation insurance can also be placed outside of the context of a deal to unlock liquidity and improve financial outcomes. Aon has worked with a number of large corporations and financial sponsors to use these solutions to hedge against potential material tax and litigation exposures to address capital management issues. Additionally, Aon's Intellectual Property Solutions can help companies augment and validate the value of certain intangibles, an important consideration in challenging times like these.

US STYLE W&I POLICIES

In 2019 and 2020 we worked on several cross-border transactions where the parties involved were US PE funds or US-based target entities. One notable feature that arose out of this was the ability of Australian and New Zealand insurers to be able to provide enhanced US-style coverage features under an Australian/New Zealand policy.

It is typical in US sale agreements to have disclosure against a disclosure letter rather than a data room. We have structured policies in Australia and New Zealand with US typical enhancements including removing the disclosure exclusion, removing the concept of a de minimis and introducing a materiality scrape. We have seen insurers work with their international teams to ensure they are comfortable offering such enhancements and have priced such policies appropriately (pricing is in between US and Australian style pricing, i.e. usually between 2% to 2.5% of the limit of liability).

CLAIMS

In addition to the placement teams assisting on claims, Aon has a dedicated claims advocate for W&I insurance. Our claims teams are also supported by a wider team of claims specialists in Asia, the US and Europe. Due to the significant premium volume that Aon places into the market, we are able to build on considerable market leverage to help our clients get their claims paid.

Aon is committed to supporting its clients over the long term and will be there when you have a claim. From the period between December 2017 to July 2020, claim notices were received by Aon on almost one in five W&I insurance policies. Claims notices are most frequently lodged within six months of a policy being put in place. Typically, the most common types of W&I insurance reported breaches were in the areas of financial statements, compliance with laws, material contracts and tax. Insurer data also shows that larger deals bring higher claims frequently and generate the largest average claim payouts.

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