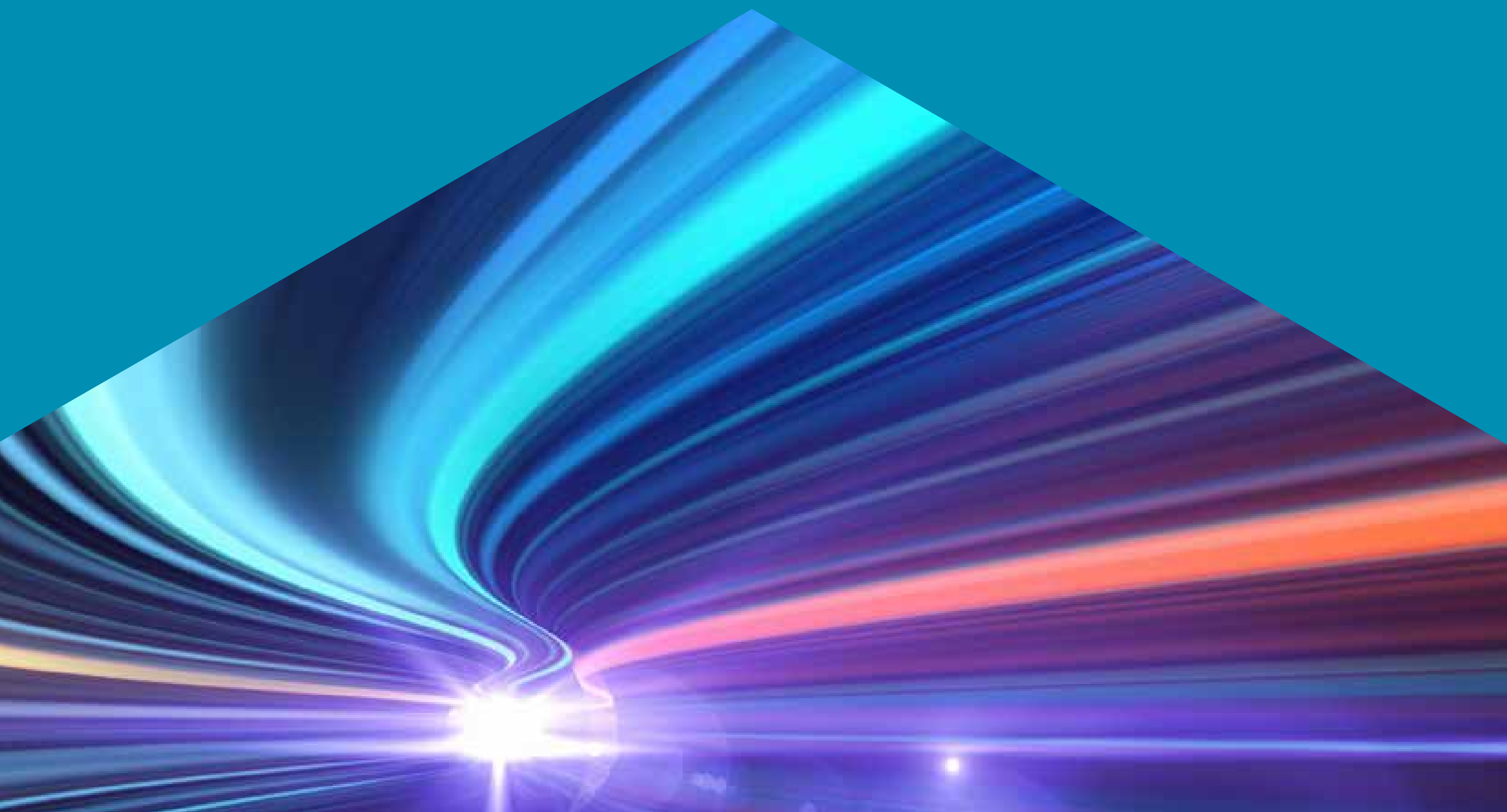
Mergers and Acquisitions Market Update Q1 – 2019

Empower Results®

Overview

- 2018 was the largest year for Aon in warranty & indemnity (W&I) insurance uptake to date in Australia, New Zealand and globally – indicators signal that 2019 will maintain this momentum.
- The number of new insurers in the market has continued to increase – resulting in more insurance capital coming to the market and driving competition between insurers.
- It continues to be a buyer's market for W&I – good for corporate clients who are increasingly using the product, public companies going private, real estate funds and private equity (PE) exits and acquisitions.
- Requests and uptake for US style disclosure regimes when structuring W&I insurance programs have been a feature throughout 2018.



State of the Market

Growing Market, Cheaper Premiums

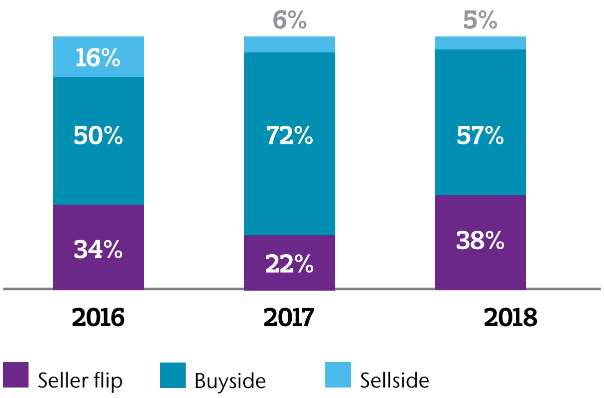
The uptake of W&I insurance on deals continues to grow globally. It has become an increasingly attractive proposition for corporates, public companies, real estate funds and PE clients. With new insurers entering into the Australasian region, this has driven a number of 'client friendly' market trends in 2018. For example:

- Pricing for W&I has become more cost effective than ever – plummeting rates for excess pricing (i.e. pricing for layers of insurance above the primary layer) has significant impacts on the costs of insurance, particularly on larger deals.
- Primary rates (i.e. pricing for the first layer of loss above the deductible or retention) remain low and steady.
- Average premium rates in 2018 continued to be below 1% of the limit insured as larger programs are structured.

Competitive Terms and Lower Retentions

In addition to low premium rates, tipping or lower retentions/deductibles were purchased on half of Aon's Australasia deals placed in 2018. Insurers are increasingly able to offer retentions that tip to nil, such that there is recovery from the first dollar of loss once the deductible is exceeded. Clients are now electing to take up retentions that are below the standard 1% of enterprise value and this is now a regular feature offered by most insurers.

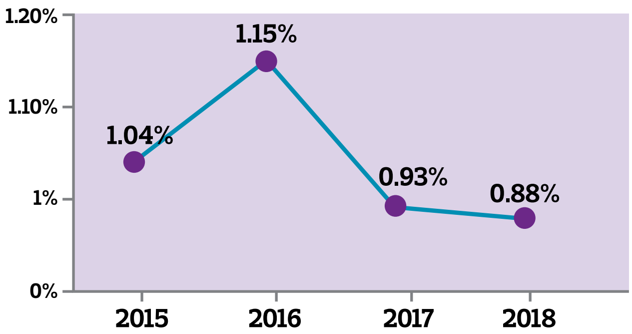
FIGURE 1: Insured structure: Growing prevalence of buyer-side policies and seller mandated processes



Source: Aon proprietary data

FIGURE 2: Premium movement

Premium rates have continued to decrease due to excess rates dropping and larger programs being placed, bringing the cost of insurance down



Source: Aon proprietary data

2017 – 0.72%

2018 – 0.70%

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

2018 – 50%

2017 – 44%

Tipping retentions or lower fixed retentions were taken up in almost 50% of 2018 deals

Industry Trends

2018 featured deals across a wide range of industries, including, but not limited to, Professional and Financial Services, Software/Technology, Food and Beverage and Resources/Industrial Services. We anticipate that clients in these industries, along with other sectors such as Mining Services, Agriculture, Real Estate and Health will continue to see the benefits of using W&I insurance.

Coverage and underwriting appetite remains largely unchanged; however, insurers are focusing on specific underwriting areas depending on the industry of the transaction.

Software/ Technology

The M&A press has highlighted, and Aon has recorded, a rapid increase in software/technology deals.

With new data breach notification laws and heightened global scrutiny of data handling, cyber risks have been thrown into focus and this has become a heightened area of underwriting scrutiny for insurers. Insurers want to understand the processes and procedures in place to prevent any breach of data security laws applicable to the target group or any unauthorised use of access of the IT of the target group. Our M&A team works closely with our specialist Cyber consultants to ensure that we understand the cyber risk profile presented by a particular transaction and how to mitigate and transfer these risks appropriately.

Professional and Financial Services

The recent Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry has increased the scrutiny by W&I insurers on matters related to financial advice, professional indemnity, anti- bribery and corruption and cyber risks.

In the event the target group has operations in Asia and other jurisdictions outside Australia, insurers will focus closely on where anti-bribery and corruption risks are prevalent.

Food & Beverage

M&A activity in the food and beverage sector has always been active and continues to be an attractive industry for strategic buyers – and also for insurers.

Key underwriting areas of focus on food and beverage deals include product liability and product defects/ tampering. Insurers will expect to see a robust risk framework in these areas and a sufficient level of insurance coverage. Insurance due diligence is critical to providing W&I insurers with comfort in these areas.

Resources/ Industrial Services

In these sectors, insurers tend to focus on understanding any exposures emanating from the condition of the plant, property, equipment and assets, and product liability and professional services/indemnity matters. Other areas of focus include property rights (including planning, easements/access rights), heritage/indigenous rights, access rights, permits, authorisations and the material project agreements.

W&I insurers will seek to ensure that the risk in respect of the remediation of identified pollution rests with a specialist environmental solution rather than under the W&I insurance. Aon's specialist Environmental Services Group will work closely with the M&A team to structure the appropriate risk transfer solutions.

Aon Broking Innovation Provides Distinct Advantage

Lloyd's
infrastructure

20%
unique co-insurance capacity

Automatic
follow-form

Extensive eligibility for clients

Through our ability to harness data and analytics, Aon created a unique and innovative insurance solution exclusively for our clients: Aon Client Treaty (ACT).

The use of ACT on large or complex placements provides our clients with a distinct advantage, especially given a rise in larger deals and a growing need for excess insurance capacity. It allows Aon to achieve the most efficient pricing with market leading coverage.

The ACT is a broking innovation enabling eligible Aon clients to automatically access 20% of dedicated Lloyd's of London co-insurance capacity attaching to underlying placements. This additional 20% capacity is guaranteed on a follow-form coverage basis.

Looking Ahead – Trends For 2019 and Beyond

W&I Insurance not just for Private Deals

Traditionally, in transactions by way of a Scheme, buyers would not receive the benefit of receiving any meaningful operational warranties or indemnities for the target business being acquired. W&I insurance has matured to provide an insurance solution that facilitates the provision of meaningful warranties to the buyer by the target company and post completion recourse for a buyer for breach of warranty and indemnity.

The use of W&I insurance on public deals is a growing trend in the Australian and global markets. The evolution of W&I insurance into the public to private sphere opens a solution to facilitate the provision of meaningful warranties for a buyer in a Scheme document. The warranties and indemnities given by the target under the Scheme document would still need to be negotiated between the parties and also subject to a customary disclosure and qualification regime akin to private deals. If these are not captured in the Scheme document itself, then these would need to be a feature of the policy. The process and pricing for W&I insurance on public deals is similar to private deals. This makes it a compelling solution to adopt on public target deals where a buyer is seeking customary warranties.

Specialised W&I Product for Real Estate Transactions

Aon has developed an innovative real estate solution tailored to address the risks presented in the acquisition and disposal of real estate. It captures key policy features designed specifically for real estate transactions to achieve both a clean seller exit as well as fulsome protection for buyers. Based on our understanding that risks in real estate transactions are distinct from other transactions and require a fundamentally different approach, Aon's Real Estate Solution offers lower premiums as well as lower deductibles and nil deductibles for certain types of claims, amongst other benefits. This will be an attractive option to clients in 2019 and beyond.

Title Insurance

Title insurance is increasingly used as 'bolt on' product to W&I. Title insurance can insure up to 100% of asset value to cover title to the shares, units and property assets in excess of the W&I insurance policy limit at very competitive rates a fraction of standard W&I rates. Cover also lasts for as long as the insured owns the asset, not just for the warranty period given under W&I.

Title insurance can provide cover for known problems found during the due diligence process. We have been able to structure Title insurance with carriers in Australia and NZ at very cost-effective rates. We have seen a noticeable increase in demand for stand-alone Title insurance, in particular given the spike in W&I for real estate transactions.

Hybrid W&I and Environmental Coverage

Environmental risks are some of the most difficult risks to provide cover for in W&I insurance. Long term environmental liability policies can help reduce the uncertainty by capping the cost of pollution risks and covering losses arising from historical pollution events that pre-date the transaction. Aon can structure coverage that provides one 'single' deductible that sits across both the W&I policy and the environmental policy. Claims under the W&I policy and the environmental policy would both go towards eroding the one shared deductible and, once reached, covered claims under either policy will be paid, providing a seamless solution across the policies.

Tax Liability Policies

The uncertainty surrounding identified tax issues can be an obstacle to strategic planning and getting a transaction across the line. Tax liability insurance transfers the risk of the identified tax issue from the taxpayer to the insurer. It provides assurance against the unexpected occurrence of a tax related cost. Tax liability insurance does not need to be used in the context of M&A. In situations where a buyer and seller are having difficulty negotiating over allocation of an identified tax risk, structuring tax liability insurance can help parties address these uncertainties and eliminate pricing adjustments. Tax liability insurance policies can be structured to cover any losses arising due to the expected tax treatment not applying (including defence costs), with fast underwriting processes and a bespoke policy tailored to the tax exposure and the transaction.

New Breach Cover (NBC)

Breaches of warranties that occur after signing and are discovered by the insured before completion (New Breaches) are typically excluded under standard cover under a W&I policy. NBC is offered by insurers on a case by case basis for an additional premium. It provides additional coverage for any breach which occurs and is discovered between signing and completion. Insurers are becoming more comfortable with offering NBC and the uptake from buyers has increased - over one third of deals in 2018 added NBC cover. We continue to work with insurers to be able to structure NBC where there have been long periods (i.e. greater than 3 or 6 months of initial NBC cover). This flexibility is particularly useful for buyers to cover off any regulatory risks in different jurisdictions.

US Style Cover

Aon has been successful in working with insurers to structure US style cover for clients in the Australian market. This is particularly relevant to US multinationals engaging in M&A in the Australasia. One of the main differences between Australian deals and US deals is the disclosure regime qualifying the warranties. It is customary in Australia to provide a much broader disclosure regime to qualify the warranties; in the US, disclosure is only against the disclosure letter and US W&I policies do not generally contain an exclusion for matters disclosed in the buyer due diligence reports and data room.

Insurers would need to gain comfort that the seller has undergone a very thorough disclosure exercise and produced a very detailed disclosure letter in accordance with the style typically seen on a US deal, which specifically discloses against each warranty provided in the sale agreement. Aon draws upon its global M&A team to ensure that we are meeting our clients coverage needs regardless of the jurisdiction in which they are conducting their M&A.

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About Aon

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