Pacific M&A Insurance: 2017 Mid-Year Report

Demand for warranty and indemnity insurance (W&I) is continuing to grow, with buyers and sellers involved in mergers and acquisitions (M&A) looking for the security the policies provide. Since 2015 two key trends have emerged: premium rates have fallen and insureds have sought to increase the limit of liability purchased. As a result, insureds are obtaining greater coverage for their money.

With continued movement and development in the W&I market and in order to provide market insight, the Pacific Private Equity and Mergers & Acquisition services team (PEMA) has conducted an analysis of the regional M&A insurance market based upon policies we placed and our observations of market conditions in the region* in 2015, 2016 and 2017 year to date (YTD).

The Pacific M&A Insurance: 2017 Mid-Year Report assesses the metrics influencing the M&A insurance market, presents a number of key trends, and forecasts potential future developments.

Marsh is uniquely positioned to conduct analysis of this kind as a globally-integrated M&A insurance advisor, having established the PEMA team over 20 years ago to assist private equity investors, corporate clients, lenders and legal and financial advisors to assess, manage and mitigate insurable M&A risk.

*Australia and New Zealand only

M&A INSURANCE METRICS SNAPSHOT

1.24% 2015 | **1.20%** 2016

PRICING HAS DECREASED FROM A RATE ON LINE OF 1.24% TO 1.20% (PREMIUM AS A % OF LIMIT PURCHASED)

1.26% 2015 | **0.94%** 2016

POLICY RETENTION HAS DECREASED FROM 1.26% TO 0.94% AS A % OF ENTERPRISE VALUE

20% 2015 | **24%** 2016

AMOUNT OF LIMIT PURCHASED HAS INCREASED FROM AN AVERAGE OF 20% TO 24% AS A % OF THE PURCHASE PRICE

$5m MIN | **$300m** MAX

POLICY LIMITS RANGED FROM $5 MILLION TO $300 MILLION

M&A INSURANCE TRENDS IN 2016

LOWER PREMIUM RATES

We have experienced a general decrease in the average premium rates from 1.24% rate on line (ROL) in 2015 to 1.20% in 2016 fostered by increased competition amongst insurers. Rates in 2017 YTD are slightly lower again. In particular we witnessed cost-effective premium rates for primary insurance in regards to transactions with enterprise values between AU$800 million and AU$1 billion.

The lower premium rates are the result of greater competition between underwriters as well as an aggressive broking market. In the Pacific marketplace, there are a relatively small number of "marquee" transactions per year (i.e., enterprise values greater than AU$1 billion), and as a result competition between underwriters for these large desirable insurance programs is fierce. Additionally, there are a number of insurers who will only consider excess positions, meaning the market for high excess positions is intense. This has resulted in premium drop-down rates which reduce sharply as capacity is deployed up the insurance tower. Insurance programs of greater than AU$200 million are routinely coming in at less than 1% ROL (inclusive of brokerage fees).

INSURED-FRIENDLY RETENTION STRUCTURES

Over the last year, M&A insurers have shown greater appetite to offer more insured-friendly retention structures. These options include retentions of 0.5% of enterprise value fixed, 1% of enterprise value tipping to 0.5% of enterprise value, and 1% of enterprise value tipping to nil.

While the 1% tipping to 0.5% retention options have been negotiated and generally offered in the market over the past few years, the 1% tipping to nil retention was a new trend for 2016 which has continued into 2017. This is due in part to the additional competition caused by new entrants to the W&I marketplace and increase in share purchase agreements (SPAs) containing such structures and therefore a push for insurers to match the SPA.

This new retention option is a key differentiating factor in selecting between insurers. In our observation, buyers and/or sellers are often willing to pay additional premiums in order to see their deductible waived or partially removed once the amount of loss exceeds the retention.

Insurers have continued to offer aggressive retention structures in 2017 YTD and we expect the take up rates of these fully tipping retentions will increase. Relatively new market entrants are still inclined to offer more aggressive pricing for retention tipping to nil options in order to differentiate their offerings.

STRATEGIC BUYERS v FINANCIAL BUYERS

In 2016 and 2017 YTD we have experienced an increase in the number of transactions arising from strategic buyers fueling their growth through a series of bolt-on acquisitions. However financial buyers are generally more inclined to purchase more extensive coverage and prefer to take out policies with higher policy limits as a percentage of the enterprise value in order to mitigate transactional risks. This practice is perhaps due to several factors including the longstanding use of the product by private equity (PE) firms (and their commensurate comfort with the policy mechanics), as well as the structuring of most PE funds, in which they owe specific duties to their limited partners and investors. These investment mandates have made financial firms keenly aware of the implications of risk reduction and allocation strategies.

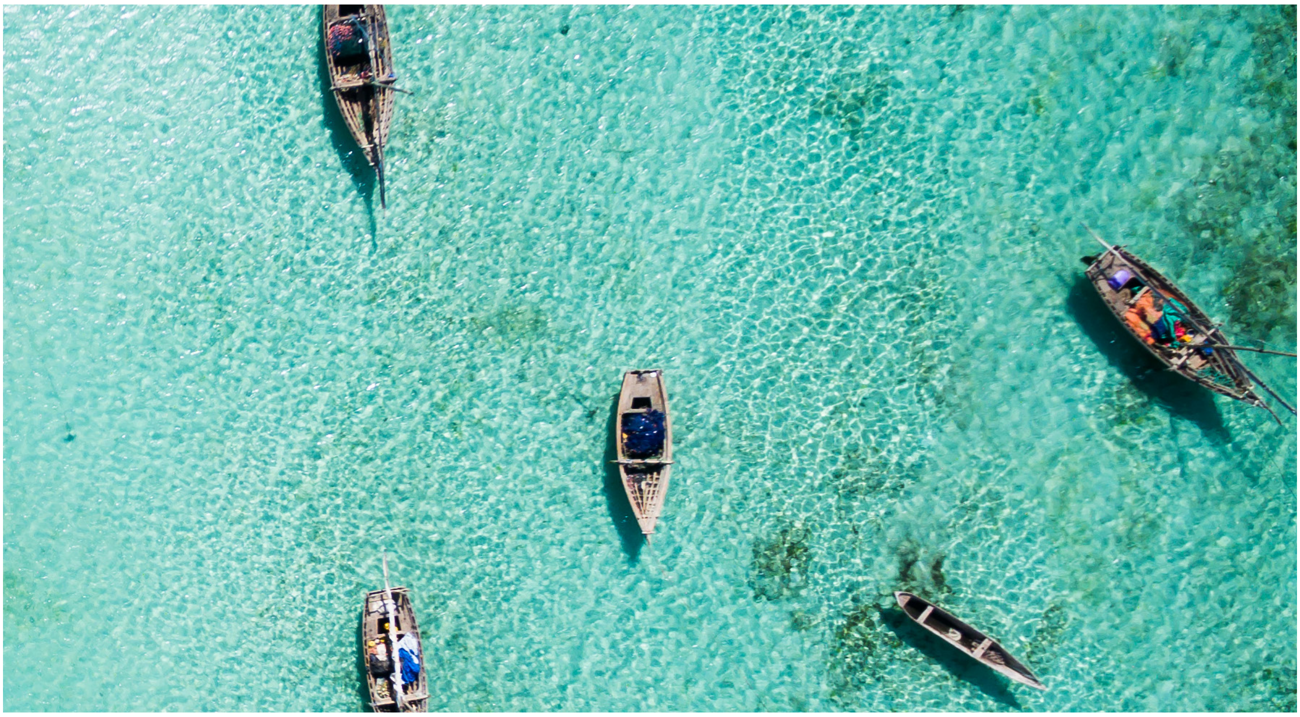
SECTOR ACTIVITY

In 2016 we saw an increase in the M&A activity in the manufacturing, healthcare and technology sectors. Thus far in 2017, we have not witnessed a particular industry focus.

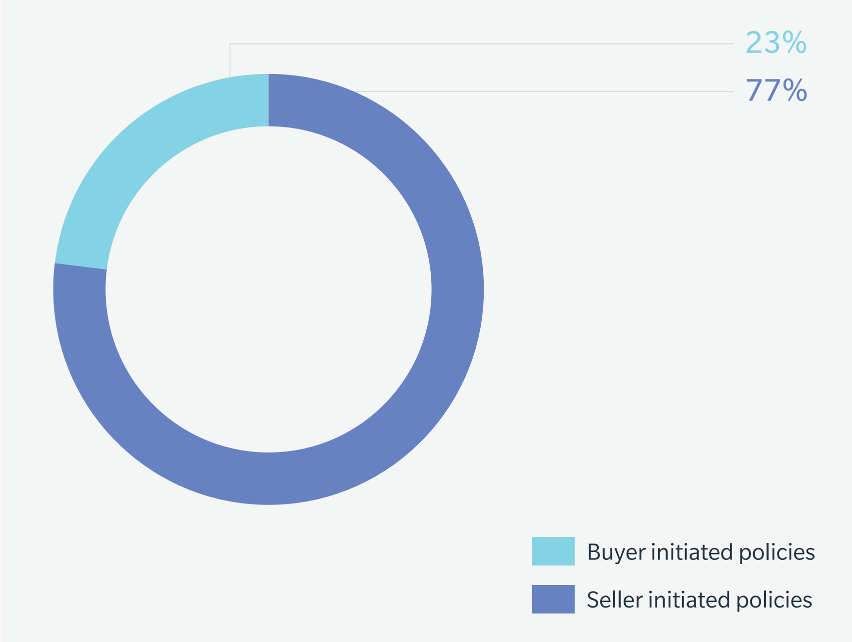
Manufacturing has been growing consistently over the last few years, attracting great attention from both corporate and PE investors, particularly the food manufacturing sub-segment. Risks in the sectors abound across the production chain with buyers requiring warranty protection in regards to material contracts with suppliers, sub-contractors and clients, intellectual property, licensing and franchising arrangements, sufficiency of assets, lease arrangements, and employees (including employee vs contractor issues).

Healthcare is also one of the top sectors seeing a high W&I penetration rate due to its status as a regulated industry involving sensitive data and privacy issues. Buyers seek warranty protection in relation to compliance with laws, employees, occupational health and safety, lease arrangements, data protection, privacy, licenses and employees (including employee vs contractor issues), and regulatory compliance.

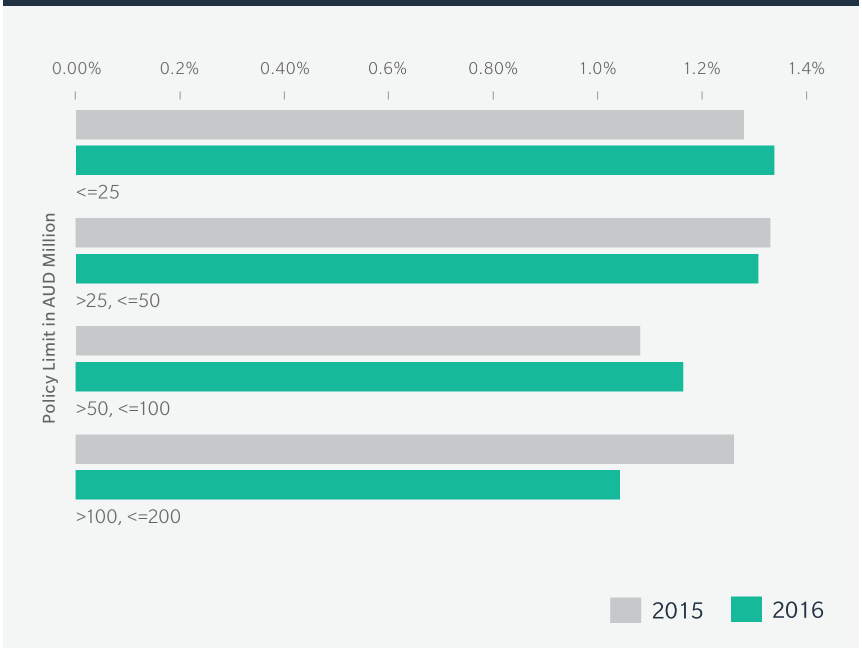
Technology attracted significant W&I interest in our panel of deals as an intrinsically disrupting sector exposed to numerous risks. W&I policy has been preferred as a risk allocation tool to address issues related to intellectual property, adequacy and enforceability of licenses and permits and IT & data protection.



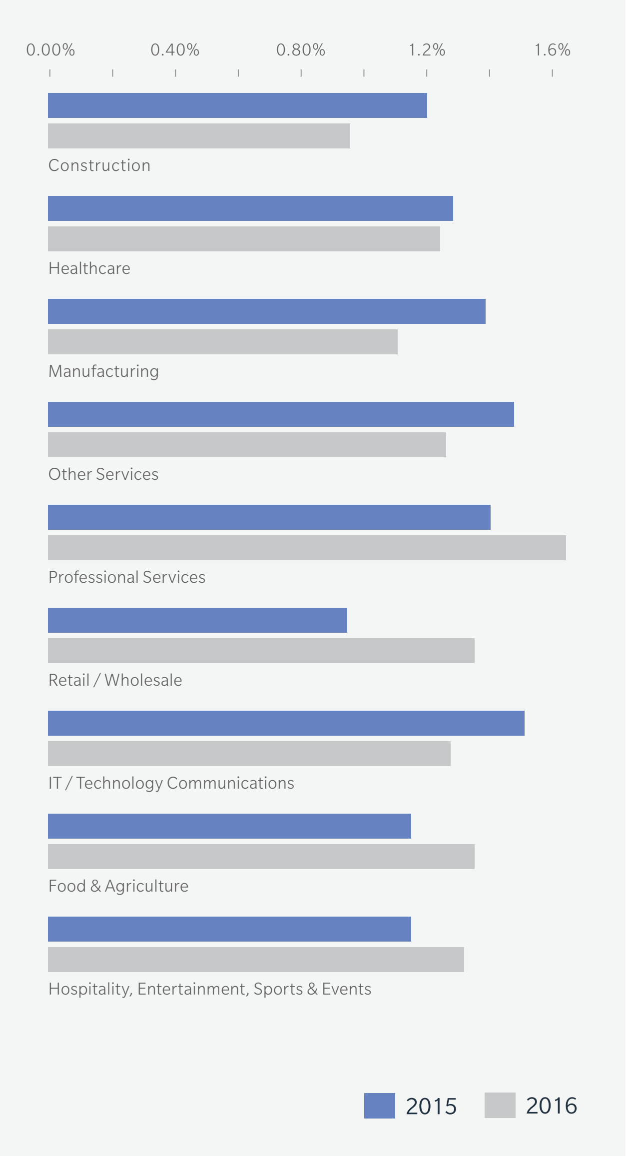
SELLER INITIATED/ BUYER INITIATED POLICIES IN 2016



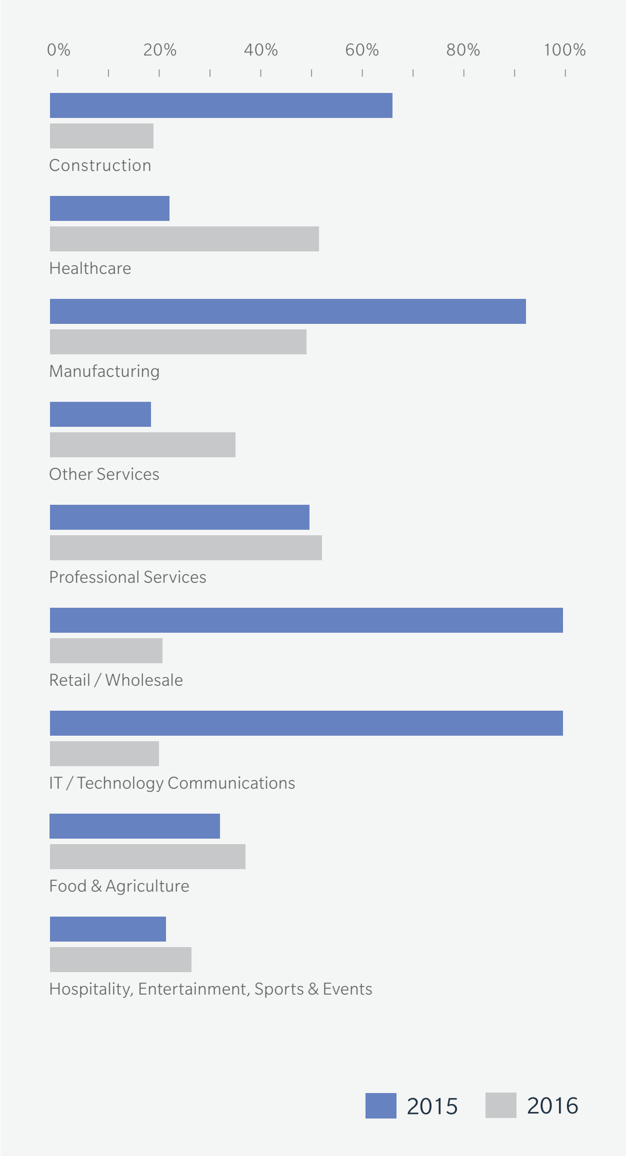
AVERAGE PREMIUM RATE AS A % OF POLICY LIMIT BY POLICY LIMIT RANGE



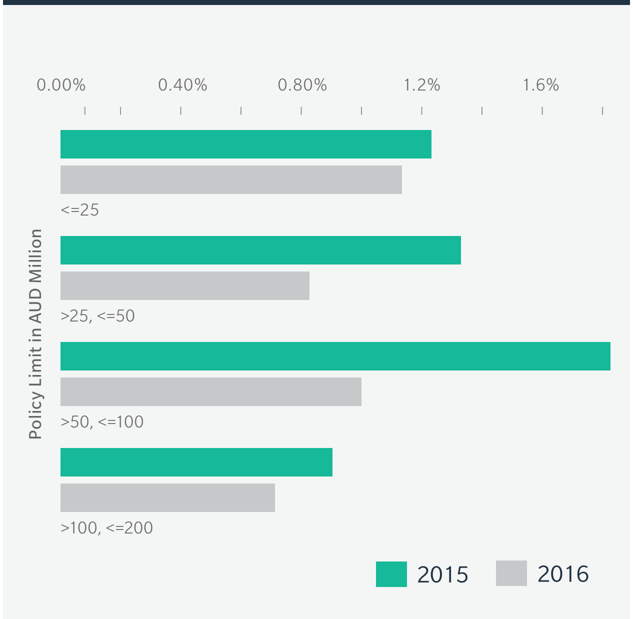
AVERAGE PREMIUM RATE AS A % OF POLICY LIMIT BY SECTOR



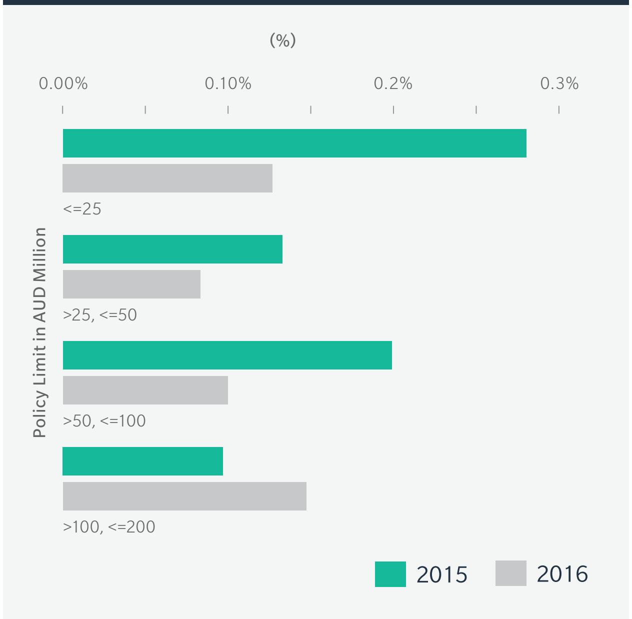
AVERAGE POLICY LIMIT AS A % OF ENTERPRISE VALUE BY SECTOR



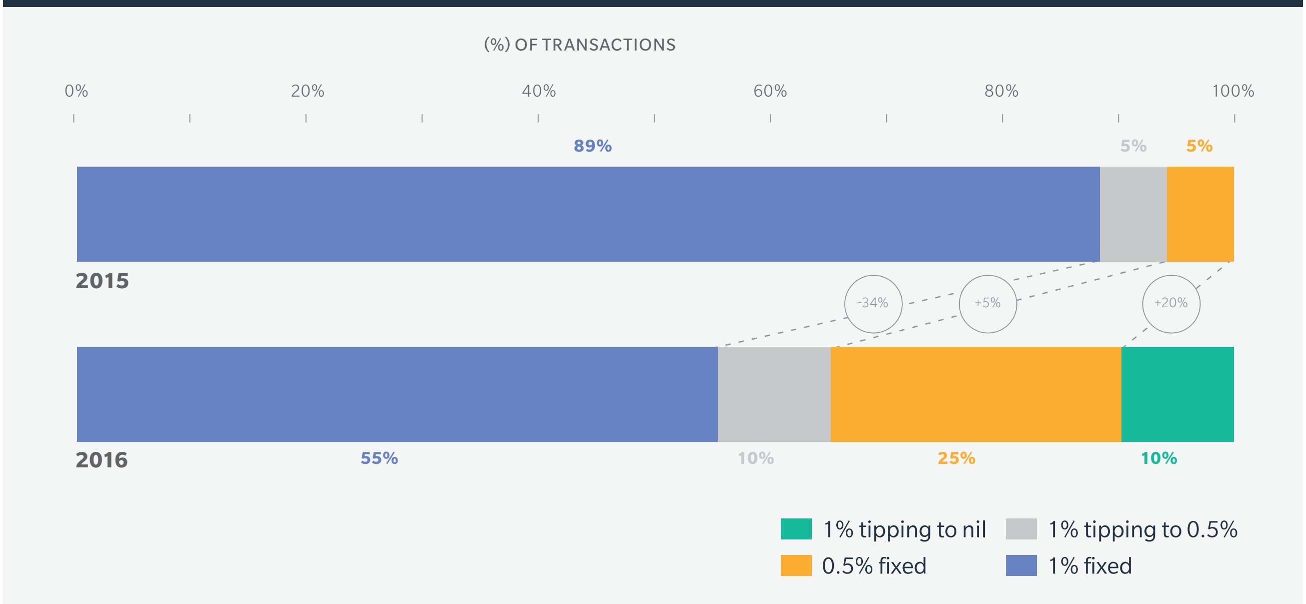
AVERAGE POLICY RETENTION AS A % OF ENTERPRISE VALUE BY POLICY LIMIT RANGE



AVERAGE POLICY DE MINIMIS AS A % OF ENTERPRISE VALUE BY POLICY LIMIT RANGE



RETENTION OPTIONS BREAKDOWN BY % OF POLICIES



PREDICTIONS FOR REMAINDER 2017

Premium softening and more insured friendly retention options being offered as a result of increasing competition amongst insurers

Growth in the W&I penetration amongst corporates sustaining their growth through mergers and acquisitions

Increase in the insurance capacity available due to existing markets increasing capacity and new insurers entering the market

Increase in W&I insured cross-border transactions as more Asian and North American buyers are screening Australian and New Zealand targets

Increase in seller-initiated and sell-side policies

Increased interest in "U.S. style" disclosure

MARSH

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