howden M&A

Claims Report

2023

Market overview

While the surge in M&A activity during 2021 has receded, the market for deals is still active: M&A volumes and values in 2022 were in-line with pre-pandemic levels[1] and the market for Warranty and Indemnity (W&I) insurance, and the wider suite of M&A insurance products, continues to grow.

The expansion of the W&I insurance market is naturally linked to the level of M&A activity, but this is far from the only factor. The adoption of W&I insurance is being driven primarily by a growing recognition of the value it brings to transactions: it brings greater certainty to both buyers and sellers, reducing risk on both sides of the table and allowing transactions to complete with increased confidence.

As we navigate a period of economic uncertainty, the value of insurance increases even further. In the months and years ahead, businesses will face a different set of challenges and we can expect the volume of distressed deals to increase. At the same time, downturns create opportunities for business consolidation and transformation.

As such, the stakes are becoming greater, and the value of W&I insurance is clearer than ever.

[1] White & Case M&A Explorer (whitecase.com)

Executive summary

- The notification rate for W&I insurance rose slightly in 2022 to 9%, but remains in line with long-term trends. Given the long tail nature of W&I policies we could see this 2022 rate increase over the next 12-24 months.
- Notifications are being made later, with a significant rise in notifications two or more years after policy inception.
- Larger deals continue to have a higher notification rate than other transactions, but notifications from smaller deals (€50m and below) are rising.
- Real estate transactions continue to attract a lower notification rate than those involving operational companies. However, real estate has shown a rise in notification rates relating to tax issues.
- The most common breach events on operational deals include financial statements and compliance with laws.
- Notifications on specific tax policies have increased by approximately 200% since 2021, reflecting the growing use of the product on complex risks.

Notification rates

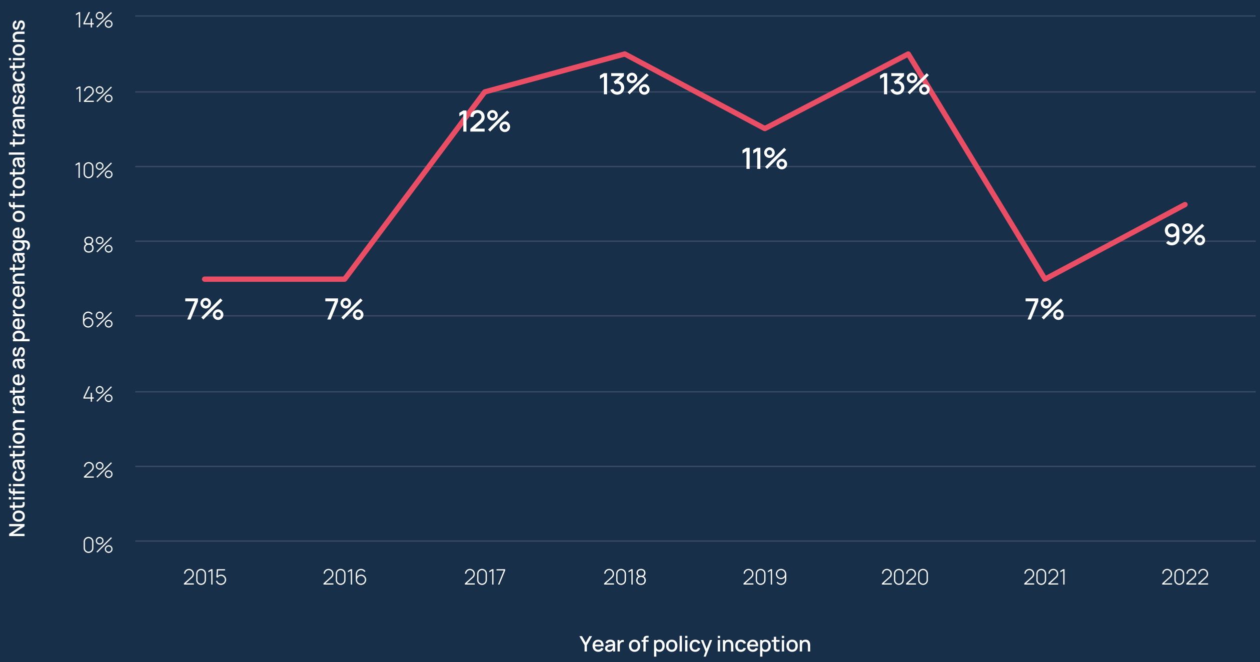
2022 notification rates tick up

Notification rates are a key measure of the M&A insurance sector. A notification takes place when a policyholder alerts an insurer that it has discovered circumstances that may constitute a warranty breach, though not all notifications result in a loss. A single M&A transaction may also result in more than one claim.

The notification rate in 2022 (up to September) stood at 9%, up from 7% over the previous period.

Taking a longer-term view, illustrated in the graph below, notification rates were markedly higher between 2017 and 2020, and the 2022 rate is in line with the rolling average over the last eight years.

Notification rates

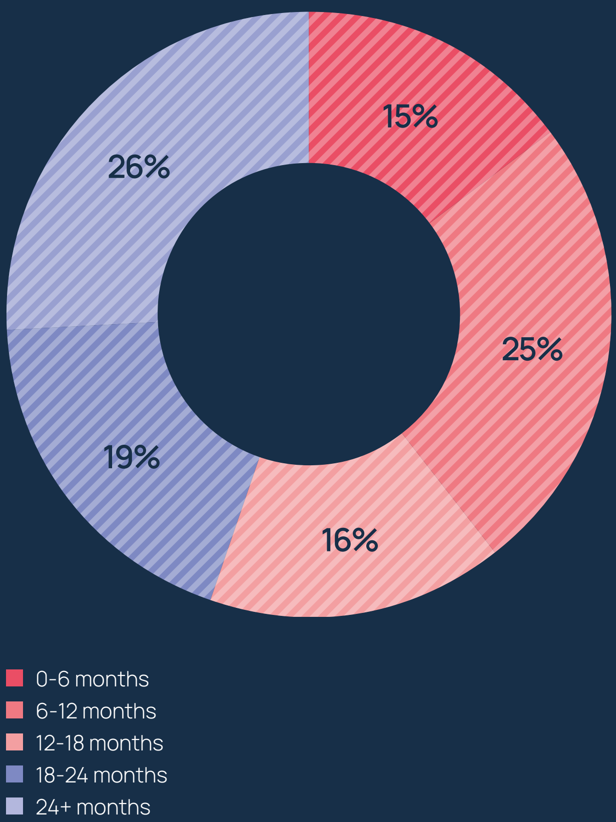


The 2022 report calculates the notification rate based on the year of policy inception. Our previous claims report calculated the notification rate based on the number of notifications received, represented as a % of deals undertaken by Howden M&A over the same period.

Timing

The average time elapsed between policy inception and notification continues to lengthen. In 2022, 15% of notifications were submitted within six months of the policy's inception, down sharply from 25% in 2021. Meanwhile, 26% of notifications were made more than 24 months after policy inception, up significantly from 13% in 2021.

Notifications by time elapsed since policy inception



CASE STUDY

Notification received 24+ months after policy inception

The seller did not disclose that the target, a UK property fund, failed to operate PAYE accounts and had not paid income tax. This issue in breach of the tax warranties, was discovered following an internal review and provides a rare example of a claim being uncovered internally (rather than via third-party claim) after 24 months of the policy's inception.

Later notifications reflect one of the great unknowns in M&A: third-party claims. The vast majority (80%) of notifications made 24 months or more after policy inception are third-party claims and most of these relate to tax audits. The timing of such claims is entirely dependent on the third party and so cannot be foreseen easily. This, of course, means that such third-party claims, and in particular tax issues, are extremely difficult to anticipate in due diligence. The rising level of these later notifications demonstrates the value of M&A insurance in providing comfort and security around these unknowns.

By providing that security during deal negotiations, M&A insurance allows for faster and smoother discussions. Further, should issues arise after completion, cover provides a mechanism for resolving matters in a less adversarial manner than an uninsured claim against a seller.

Inevitably, as the number of insured transactions increases, the number of later notifications may continue to increase. It will be interesting to see whether this trend continues and whether, once the market is fully mature, the pattern of timing for notifications stabilises.

Outlook for notifications

We expect notification rates to rise once again over the coming year and beyond. This will be partly due to the natural lag between transactions and notification of a claim. More than half of all M&A deals in 2021 (58%) took place in the second half of the year and, with a significant proportion of notifications taking place a year or more after inception, many notifications from the M&A boom have not yet materialised. A combination of narrower diligence scopes and overstretched advisers over the course of 2021 will also likely reflect in higher notification rates.

There are two further factors we expect to play a role in rising notification rates – increasing deal sizes and insurer competition. While the volume of M&A transactions eased during 2022, there has been a growth in the number of megadeals with an enterprise value of €1 billion or more. The market expectation is that deal sizes will continue to increase.[2]

In addition, the economic slowdown has triggered greater competition and appetite for deals amongst insurers, with many now offering broader cover on a wider range of transactions and taking positions which they haven't done previously. This could lead to elevated notification rates as we move through the next 12-18 months.

[2] Global M&A market slows in 2022 first half, but shows signs of strength – McKinsey

Deal size matters

Larger M&A transactions are naturally more complex. Targets are sizeable and typically involve more diverse activities, subsidiary businesses, a wider range of asset types and may span many jurisdictions. Inevitably, due diligence is harder, conducted by sample and the room for unexpected issues is therefore greater.

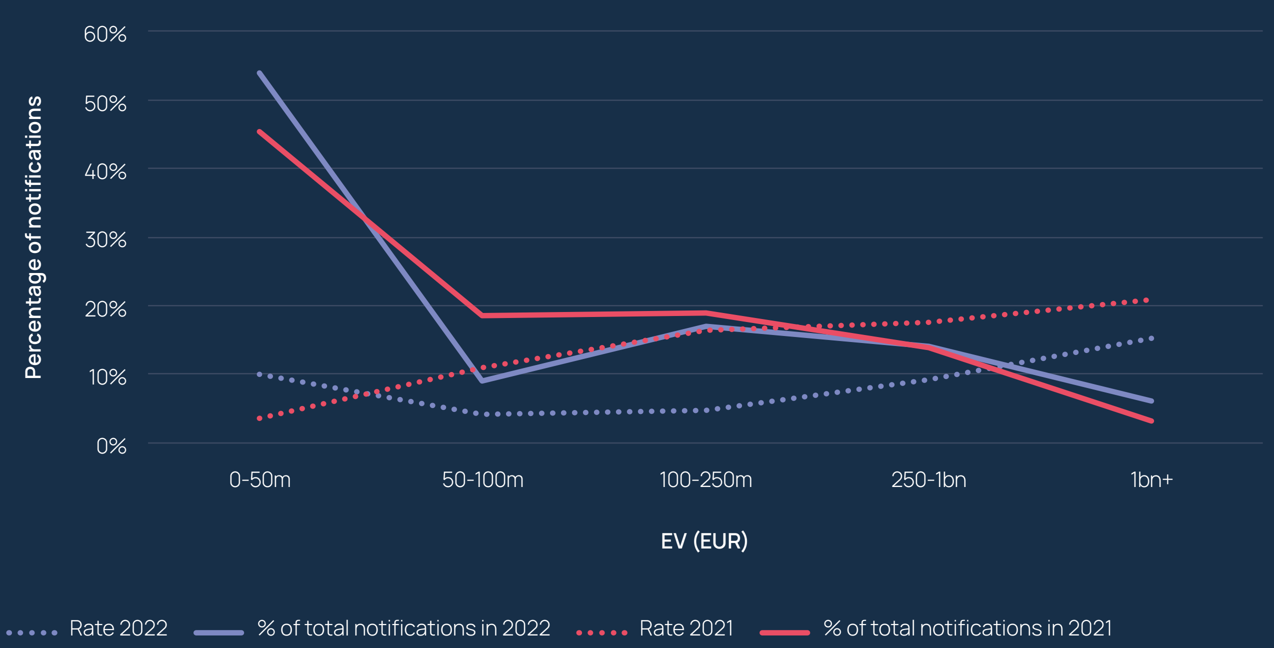
The notification rate for deals with an enterprise value of €1 billion+ stood at 15% in 2022. This is lower than the 20% seen in 2021, but it remains far higher than for other deal sizes and we expect it to remain so.

Insurance market capacity is rising as new entrants increase the capital available for W&I underwriting of larger M&A deals. The increasing use of W&I in the biggest M&A deals will be a significant trend in M&A insurance in the years ahead, providing an opportunity for growth for insurance providers, and delivering security and protection for the biggest dealmakers.

While the notification rate for the largest deals is likely to remain relatively high and stable, smaller deals have seen a sharp increase in notifications. For the smallest deals of €50 million or less, where we have witnessed a higher volume of insured deals due to shifting insurer appetite and commercial objectives, the notification rate has more than doubled to almost 10%. This brings the notification rate for these smaller deals broadly into line with the average across all deals of 9%.

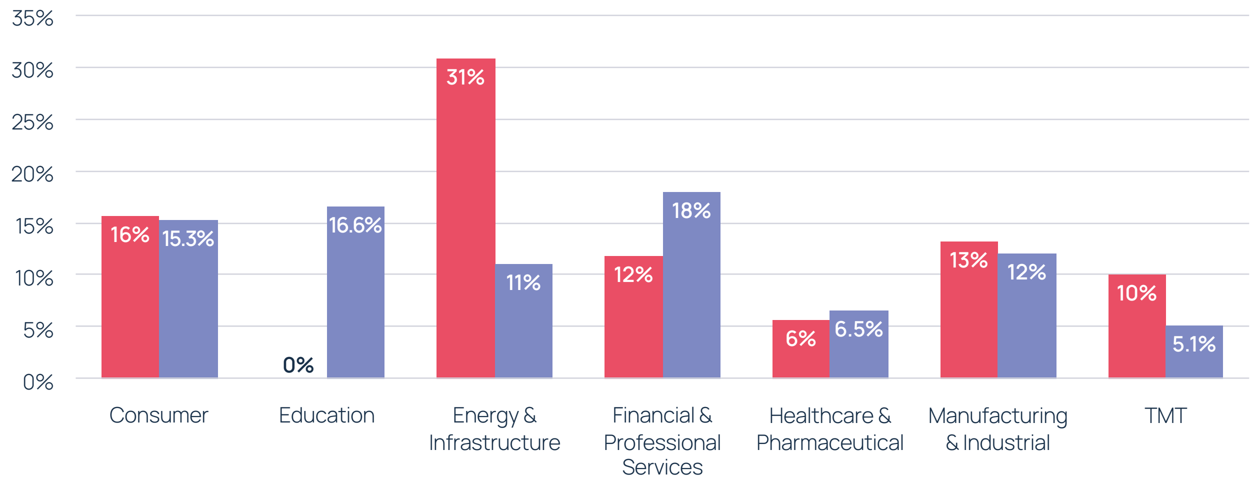
This suggests the value of W&I insurance is being increasingly recognised for smaller M&A deals.

Notification rate vs EV



Asset classes and sectors

Operational



Real Estate

Complexity is one of the key drivers of notification rates across asset classes and sectors. During 2022, real estate deals had an overall notification rate of just 5%, while deals involving operational companies had a rate of 13%.

Operational companies have many moving parts, including customer contracts, leases, supply chains, plant and machinery and, in many cases, intellectual property. The potential for issues to arise is naturally greater in an M&A transaction involving multiple elements and is reflected in the higher notification rate for operational businesses.

Notification rates also fell in most operational sectors, with particularly sharp drops across energy and infrastructure. Despite the decrease, reasons for notifications are similar and include liabilities or income misstated in accounts, contractual obligations not disclosed and tax-related claims. The consumer sector also saw a reduction in notifications.

The receding effects of the pandemic were likely to have been a factor in these falls.

Meanwhile, notifications in the financial and professional services sector increased to 18%, while there was a significant rise in notifications from the education sector, from zero in 2021 to just over 16% in 2022. This can be explained by the substantial increase in deal volumes that we experienced in this sector over the reporting period.

Notifications from the hotels sector fell from 14% in 2021 to 2% in 2022. Tax issues remained a significant factor in these notifications, but issues around financial statements receded.

Offices also saw a similarly sharp fall from about 14% to just under 5%.

CASE STUDIES

Notifications rising in education and financial services sectors

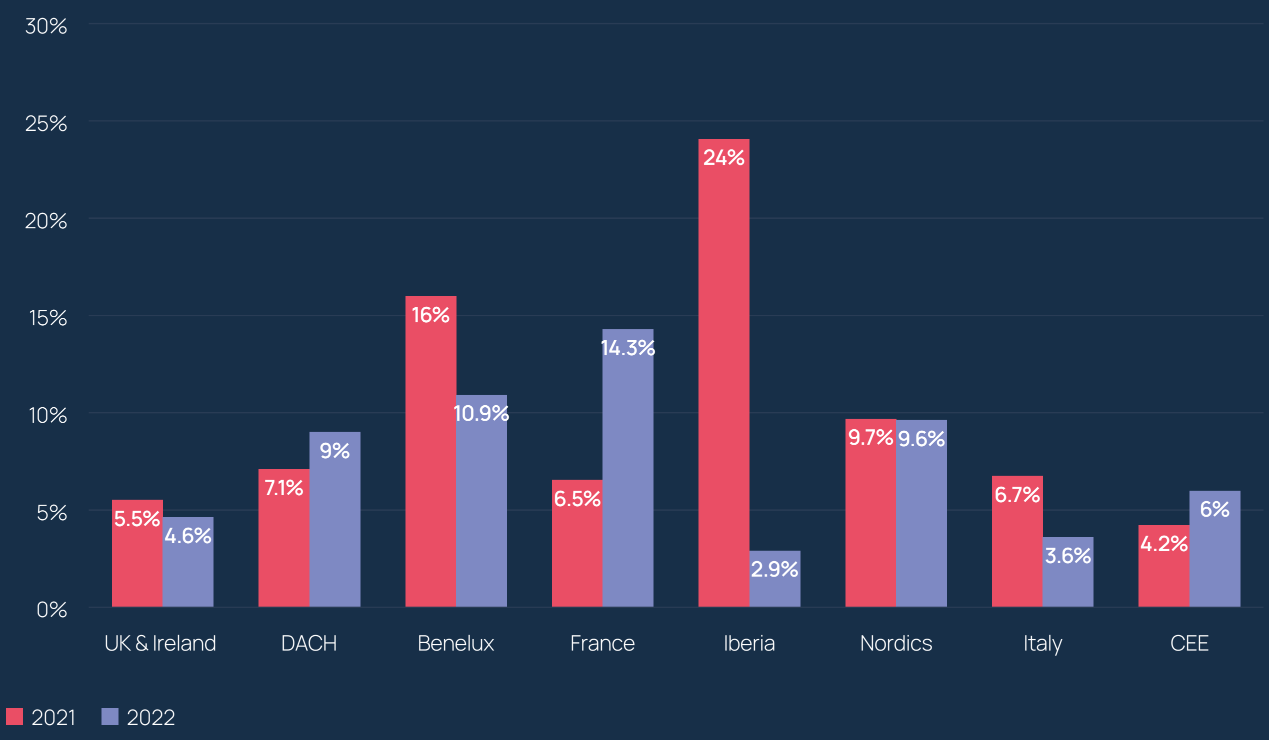
Education: Insured acquired an education provider. The seller failed to disclose the use of certain aspects of the premises contrary to planning permission, in breach of compliance with laws warranties.

Professional & financial services: Insured acquired a consumer bill payment platform. The seller failed to disclose a liability to third party due following termination of contract and no accrual for this liability was made in the accounts, in breach of the financial statements warranties.

Jurisdictions

Notification rates also vary significantly across jurisdictions. During 2022, the notification rate jumped sharply in France but dropped dramatically in Iberia. This reversed the pattern of the previous year in which rates fell in France and jumped in Iberia. The reasons for this volatility in rates are too numerous to reduce to a single cause, but local economic conditions, differences in type of M&A activity and the maturity of the M&A insurance market in each jurisdiction are likely to be among the main factors.

Notification rates across jurisdictions



Breach events

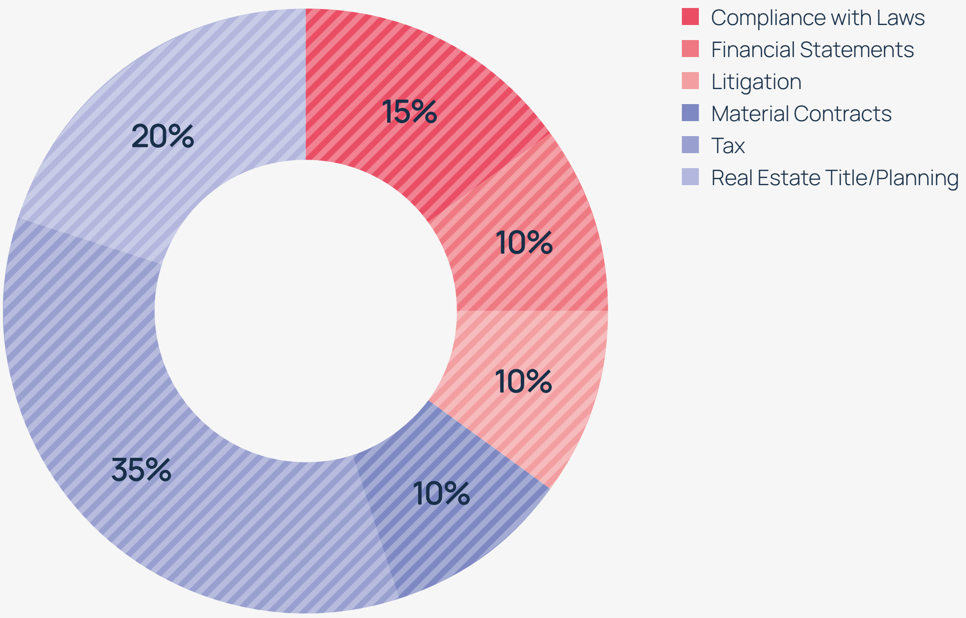
Commonly breached warranties – real estate

Real estate witnessed some marked movements in the type of warranties breached between 2021 and 2022. Tax issues were the single largest cause of a warranty breach in 2022, representing 35% of notifications, up from the 16% share of notifications in 2021. Most of these related to targets in the UK and Germany, suggesting that tax authorities in those jurisdictions stepped up their activities in 2022.

Litigation breaches accounted for 10% of notifications, up from just 2% in 2021 and warranty breaches concerning title or planning issues also rose, almost doubling to 20% of breaches, up from 11% in 2021.

These rises were offset by declines in breaches around material contracts, financial statements and compliance with laws.

Real estate breaches



Commonly breached warranties – operational

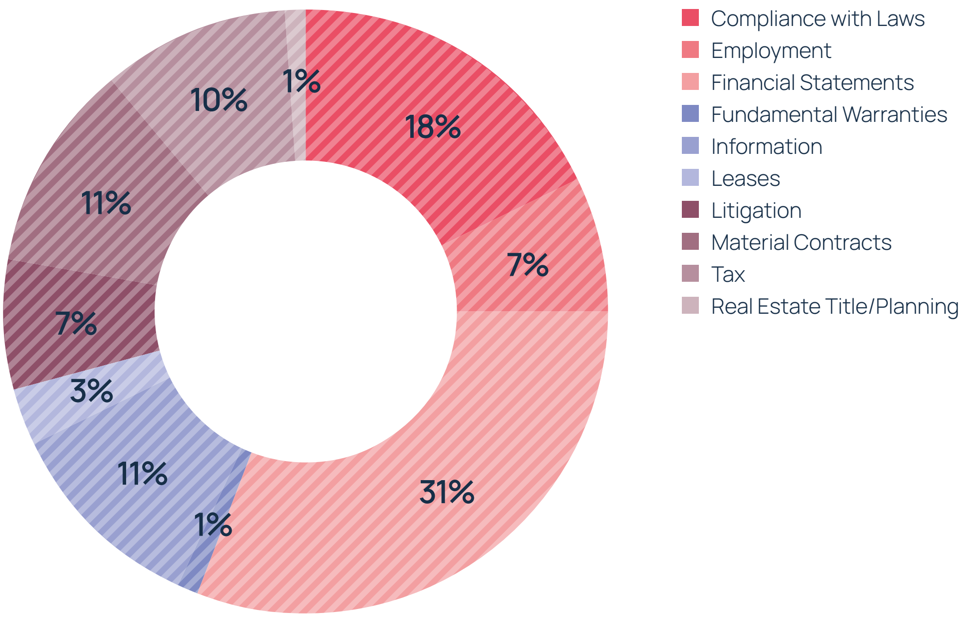
Warranty breaches involving operational M&A deals showed both similarities and marked differences from the pattern seen in real estate. **Taxation breaches in operational business fell in 2022 compared to 2021 - down from 21% to 10%.**

However, as with real estate, breaches relating to material contracts fell to 11% from 24% in 2021.

Notifications relating to compliance with laws increased from 4% to 18% of all notifications. The specific issues were varied but included, breach of employment laws, target products breaching applicable regulations, and breach of privacy laws.

Financial statements also generated a greater proportion of notifications in operational company deals, rising from 24% to 31% of notifications. Triggers included failure to accrue liabilities and overstated income, and changes to revenues linked to problems with material contracts.

Operational breaches



The fall in breaches linked to material contracts across both real estate and operational company transactions may be related to the Covid-19 pandemic when the unprecedented disruption to normal business operations and real estate use may have led to more robust due diligence exposing problems.

It is possible that the economic downturn will have a similar effect, though the shock of the pandemic might have thrown a spotlight on the importance of material contracts and permanent lessons may have been learned for contract due diligence processes.

One further notable trend has been an increase in full limit claims relating to fraud. This may have been an early sign of the economic downturn. Fraud of all kinds increases during economic recessions, as challenging times can lead to desperate actions. Rising levels of fraud means ensuring the correct level of insurance cover becomes more vital than ever.

CASE STUDIES

Commonly breached warranties

Tax warranties: Insured acquired an auto parts distributor. Seller failed to disclose target had incorrectly booked a historic tax loss as a result of writing off a loan to a connected party, leading to the incorrect payment of tax due to the understatement of taxable income. Target liable to pay tax circa €7m.

Financial statements and material contracts: Insured acquired portfolio of solar plants. Seller failed to disclose liabilities due to third parties under supply contracts in breach of warranties relating to financial statements and material contracts.

Fraud: The market is watching Austrian investment group B&C-Gruppe's claim arising out of its acquisition of Austrian packaging company Schur Flexibles. Executives of the packaging company are alleged to have misappropriated company money for personal benefit. See articles: ft.com and industriemagazin.at

Fraud: The Commercial Court (Claim No. CL-2022-000621) will consider insurers' reliance on an anti-bribery and anti-corruption liability exclusion clause to decline a claim notified following a fund's acquisition of a construction company. The insured alleges breach of the bribery and corruption warranties because the seller failed to disclose matters relating to one of the target's key contracting counterparties which are (i) confidential to a police enquiry and (ii) detailed in a report looking into the conduct of the counterparty. The target's relationship with the counterparty deteriorated as a result of these, and income from that contract would not be realised, meaning the insured overpaid for the target.

Specific risks

Tax

Notifications under tax policies have increased approximately 200% since 2021. Paid claims include full limit losses demonstrating the importance of a policy limit that captures both the tax liability and costs to defend allegations by the tax authority. Costs to defend a complicated high value tax matter will increase quickly and a limit focusing only on the tax liability may, as seen in our experience, leave the insured without sufficient cover for costs.

CASE STUDY

A tax authority investigation into target group companies inter-company loan interest rate resulted a finding the rate was too high. Insurers fully indemnified a settlement with the tax authority for all the loans within the target group companies, and some defence costs, up to the policy limit. The insured was not indemnified for the defence costs exceeding the policy limit.

Title & Litigation risks

Title notifications have stabilised. The most common insured events across all notifications made include the property use not complying with legal obligations or restrictive covenants and planning/licensing issues.

While we have some notification and claims experience for litigation risk policies, this product is still maturing and we expect to report on claims under these policies in future claims case studies.

M&A insurance delivering for policyholders

W&I insurance works. The majority of resolved claims in 2022 concluded positively (71%), with the remaining validly declined (29%). These figures show a slight increase in declined notifications from 2021, when 26% were rejected. However, we do not regard this as statistically significant as not all claims are valid, precautionary notifications are encouraged, and may fall within a policy exclusion, for example property defects or transfer pricing.

The benefits of insurance are now widely recognised as providing value to both sides of an M&A deal.

- Sellers are provided with a cleaner exit from their investment with few residual liabilities. This allows faster distribution of funds to investors or for deployment elsewhere.
- Buyers are protected against losses with cover from A+ rated insurers. This provides more secure protection than is available when the seller stands alone.

There is no downside risk to making a notification, and policyholders will quite reasonably make a notification even when the possibility of a loss caused by a warranty breach is unknown. In the tougher economic climate now emerging, it is possible the declinature rate will increase, as insured parties may take an even more precautionary approach.

Payment of claims

On average, insured parties notify a potential claim fifteen months (471 days) after the facts underlying the breach event have occurred. Meanwhile, insurers on average agree payment within ten months of that notification with 40% of claims paid in six months or less.

But while many claims are paid within a year, there has been an increase in the proportion paid 12 or more months after notification from 10% in 2021 to 30% in 2022. Rather than being a sign of foot-dragging by insurers, we believe this reflects the increasing size and complexity of M&A deals that W&I insurance is covering.

The timescale for settlement of claims naturally depends both on the speed at which the insured evidences a claim and the speed at which that notification is assessed. As both insurers and insureds become increasingly experienced in dealing with M&A claims, we expect the assessment period to shorten and payment to be made more swiftly.

Outlook & key takeaways

W&I insurance is now a standard part of the M&A toolkit, and its value in smoothing the path of transactions and providing security and protection after an event is increasingly recognised by dealmakers.

As we move through 2023 we expect to see buyers taking full advantage of the competitive M&A insurance market. Whilst premium presents another cost parties must bear, in times of economic uncertainty the need to reduce risk and release trapped cash on the balance sheet through the use of insurance is greater than ever.

In addition to improving their offering of the core W&I product through lower pricing and broader cover, insurers are increasingly willing to provide terms on deals of a more difficult nature, which is likely to lead to elevated notification rates on transactions insured over the remainder of this year. The economic slow down may also increase the number of distressed deals coming to market which may generate further upwards pressure on notifications.

If you would like to discuss any aspect of this report in further detail, or a topic not forming part of the analysis, please get in touch with Anna Robinson, Head of Claims (anna.robinson@howdengroup.com), or your usual Howden M&A contact.

Speak to Howden M&A

UK

Daniel Stock
Managing Director I Head of UK & Ireland
daniel.stock@howdengroup.com
+44 (0) 7885 462 408

Anna Robinson
Executive Director I Head of Claims
anna.robinson@howdengroup.com
+44 (0) 7860 849 922

DACH

Gennadiy Kharif
Managing Director I Head of DACH
gennadiy.kharif@howdengroup.com
+44 (0) 7834 179 003

Dr. Severin Zörgiebel
Executive Director I W&I
severin.zoergiebel@howdengroup.com
+49 (0) 179 158 0020

France

Andras Haragovitch
Director I Co-Head of France
andras.haragovitch@howdengroup.com
+33 (0) 6 47 62 23 21

Lucie Bocel
Director I Co-Head of France
lucie.bocel@howdengroup.com
+33 (0) 7 88 75 96 04

CEE

Hélène Bastien
Executive Director I Head of Central and Eastern Europe
helene.bastien@howdengroup.com
+44 (0) 7834 746 999

Julia Mikler-Mieszkiełło
Director I Head of Poland
julia.mikler-mieszkiello@howdengroup.com
+48 (0) 797 282 342

Benelux

Frederik Veldhuijzen
Managing Director I Head of Benelux
frederik.veldhuijzen@howdengroup.com
+31 (0) 613 63 10 37

Gauthier Drion
Director I Head of Belgium
gauthier.drion@howdengroup.com
+32 (0) 470 04 60 20

Nordics

Alexander Rasmussen
Executive Director I Head of Nordics
alexander.rasmussen@howdengroup.com
+46 (0) 73 528 89 24

Carl Levin
Associate Director I Head of Sweden
carl.levin@howdengroup.com
+46 (0) 70 861 76 00

Italy

Giulia Malusa
Director I Head of Italy
giulia.malusa@howdengroup.com
+44 (0) 2074 567 633

Iberia

Enrique Perez Del Castillo
Executive Director I Head of Iberia
enrique.perezdelcastillo@howdengroup.com
+34 (0) 695 211 611

Israel

Oren Werber
Head of M&A I Israel
oren.werber@howdengroup.com
+972 (0) 54 7790703

APAC

Simon Worker
Director I Hong Kong
simon.worker@howdengroup.com
+852 5598 9206

Tze Yang Goh
Director I Singapore
tzeyang.goh@howdengroup.com
+65 9827 8737

16 Winchester Walk, London, SE1 9AQ

T +44 (0)20 7623 3806
F +44 (0)20 7623 3807
E howdenmergers@howdengroup.com

www.howdenmergers.com