M&A Insurance EMEA Claims Report

2020

howden
M&A

Introduction

This report provides insight into claims trends identified from Howden M&A's claims data, derived from placing insurance on more than 1,000 transactions in EMEA over the past five years. In particular, we focus on (i) notification rates across jurisdictions, transaction sizes and industry sectors; (ii) the nature of warranty breaches and how they differ between jurisdictions and industry sectors; and (iii) payments made by insurers and reasons for declinature. We are available to discuss in further detail upon request.

EMEA claims data from the last five years
(2015-2019 inclusive)

131
notifications

23
jurisdictions

1,010
deals

In contrast with our previous claims report, we present this data on a calendar year basis as opposed to a financial year basis.

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Market overview

Update

2019 was another year of record growth for the European M&A insurance market. As the number of policies placed continues to grow, the volume of notifications is keeping apace, with Howden M&A receiving an average of more than one notification per week during 2019.

It was also the year where large claims started to be paid on a regular basis. Liberty GTS' well publicised €50m payment to FSN Capital[1], a £20m payment on a UK manufacturing transaction and a $200m+ payment on a US manufacturing transaction are good examples of how W&I insurance responds to material breaches, and how issues can be missed, even when robust diligence processes are undertaken. This is particularly the case for breaches arising from wilful non-disclosure events, a topic we investigate in further detail within this report.

Our data highlights significant jurisdictional variation across Europe, in terms of both notification rates and the underlying warranty breaches. In most cases, these differences are not properly reflected in the pricing, retentions or underwriting focus of insurers. We expect this to shift over the coming years as claims data starts to drive underwriting behaviour in a more meaningful way.

We have also identified material differences in notification rates across industry sectors, but surprisingly some traditionally more favoured sectors (e.g. manufacturing) are generating much higher notification rates compared with less favoured sectors (e.g. financial services).

This could see a shift in appetite, with more attractive terms offered on financial services deals and higher premium rates for manufacturing assets going forward.

[1] https://fsncapital.com/news/fsn-capital-gram-insurance-limit-paid/

Outlook

Whilst the rate of notifications dropped slightly versus 2018, given the far greater number of deals being insured, the absolute number of notifications rose significantly to 56 (a 44% increase versus 2018). With premium rates dropping by an average of 10% and policy retentions reducing by an average of 19%[2], insurer income has not kept pace and the divergence between income and claims has seen several insurers suffer loss-making years.

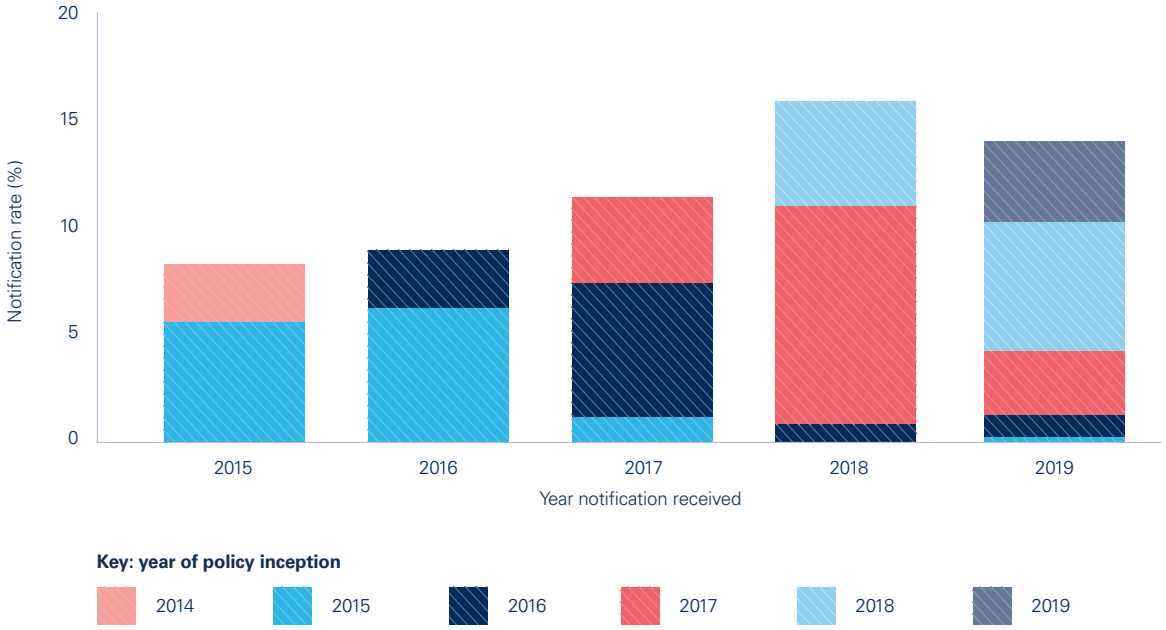
This situation is enhanced further by the COVID-19 outbreak, which has seen a rapid decline in M&A volumes and in turn premium income. Notifications will continue to be made over the coming months (the COVID-19 situation will probably drive an increase in notification rates), further impacting the profitability of insurers' M&A books. It is likely that this will result in a pricing correction, most likely in early 2021, largely driven by MGAs struggling to secure the levels of capacity they currently enjoy.

The sharp increase in policies covering known issues, in particular known tax exposures, identified pollution and defects to title, is also likely to drive an increase in non-W&I claims over the coming years. Whilst the notification rate under these policies is far lower, often the associated quantum is substantial and the policy structures give insurers very little room to decline a claim. We expect such claims to become a material portion of our claims portfolio within the next two years.

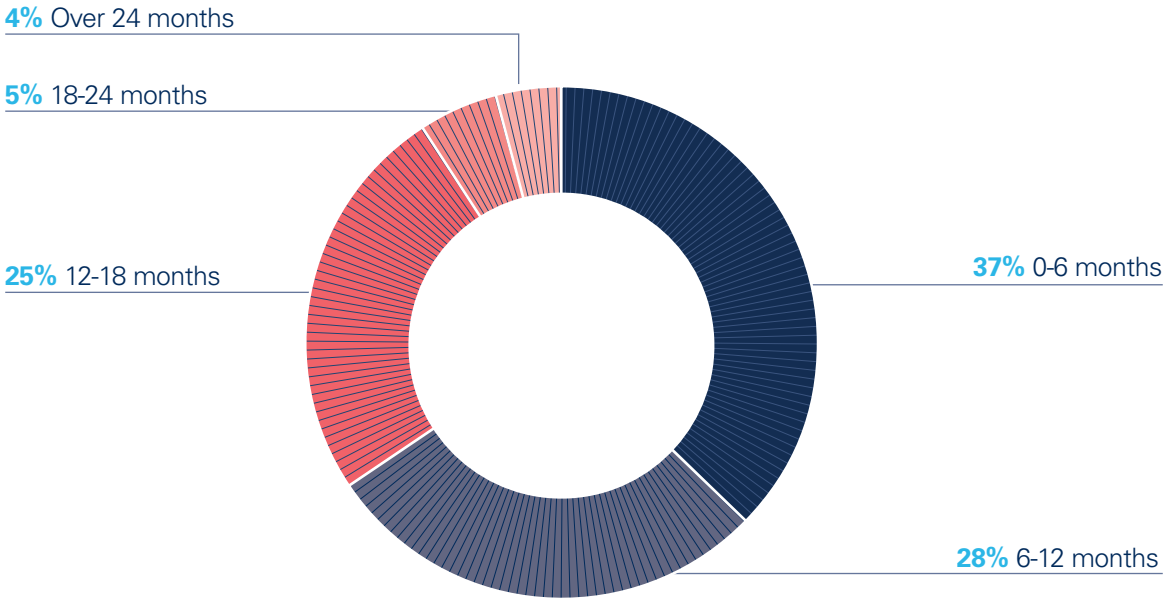
[2] Howden M&A 2019 Annual Review and 2020 Outlook

Section 1: Notification rates

Notification rates have increased over time but seem to be settling



Notifications are usually made within 18 months but have been made later

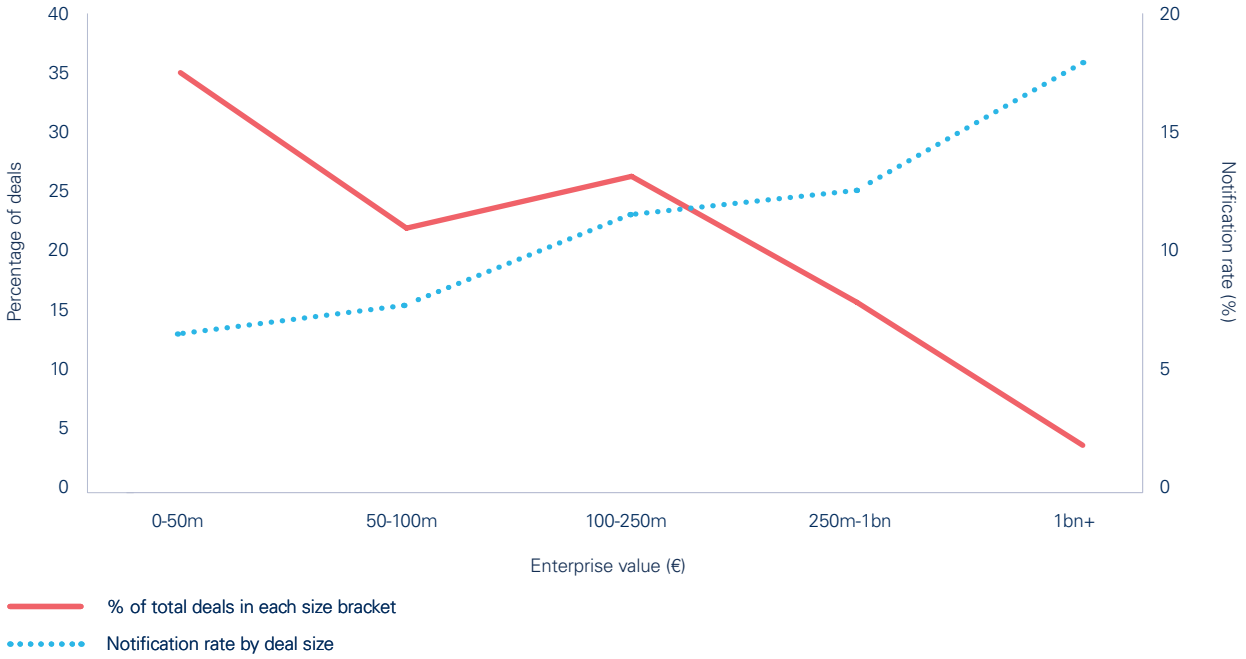


Notification rates analysis

Over the past five years, notification rates have been steadily growing across EMEA. This should not be surprising as insurers have broadened their risk appetites substantially (both from a sector and jurisdictional perspective) and insureds have become more sophisticated users of W&I policies.

What has come as a surprise to many is the "long-tailed" nature of W&I claims. Most insurers considered the realistic claim period to be two years post-completion, but recent data suggests this is not the case. Whilst 96% of notifications are made within two years of completion, some are made after that and often involve a high quantum. As can be seen in the first graph, 2019 saw notifications made against policies that bound in 2015. This has resulted in at least one major insurer extend their reserve period for W&I policies, which in turn has impacted their pricing model. We expect others to follow suit, especially as it has recently become common to extend general warranty survival period to three years, thus heightening the risk profile of policies in year three.

Large deals generate more notifications

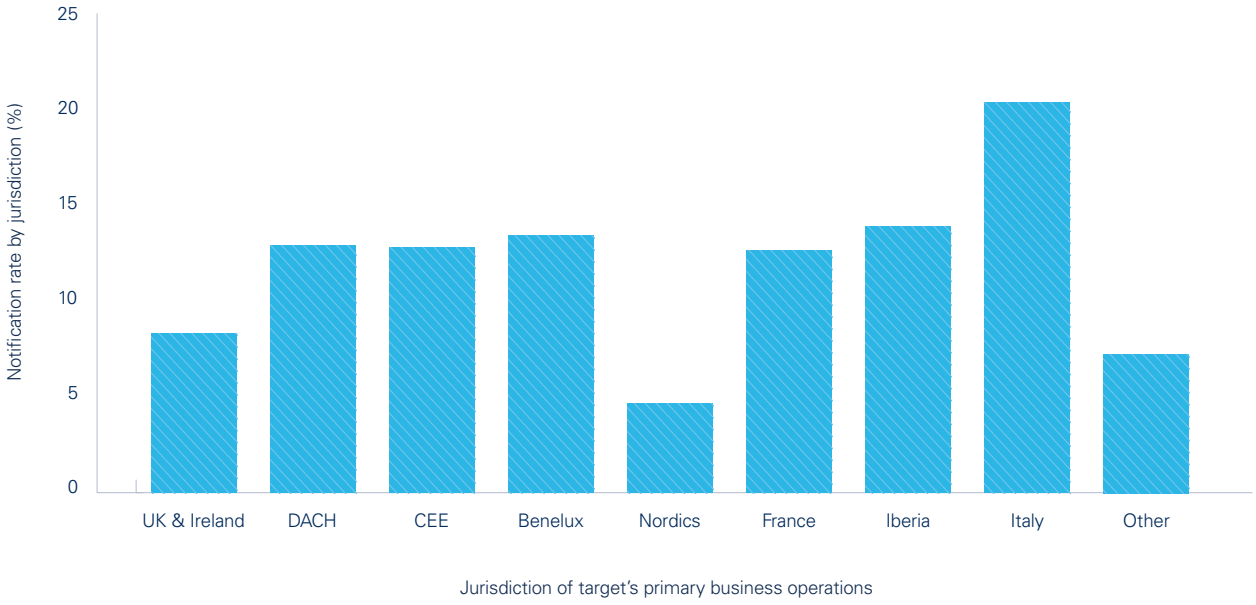


An emerging and consistent trend of the past five years has been that large deals (>€1bn enterprise value) generate a significantly higher rate of notifications versus deals <€1bn. The severity of notifications on >€1bn deals also tend to be greater. Adequately diligencing these targets is clearly a challenge and issues are often missed, particularly during fast-running auction processes. Insurers have started to work this into their pricing models, with deals of >€1bn priced higher (an average rate of 1.6% in 2019) than sub €1bn deals (an average rate of 1.0% in 2019)[3].

Small deals (<€100m) have a much lower notification rate. Deals of this size allow for advisers to undertake thorough due diligence into all areas of the business. Any issues that exist are therefore typically flushed out and dealt with via the purchase price or a specific indemnity rather than a warranty claim. This dynamic has seen a number of insurers seek to specialise in small-cap deals over the past few years, with a focus on insuring a high volume of transactions by applying a quick and light-touch underwriting approach.

[3] Howden M&A 2019 Annual Review and 2020 Outlook

Notification rates vary across jurisdictions

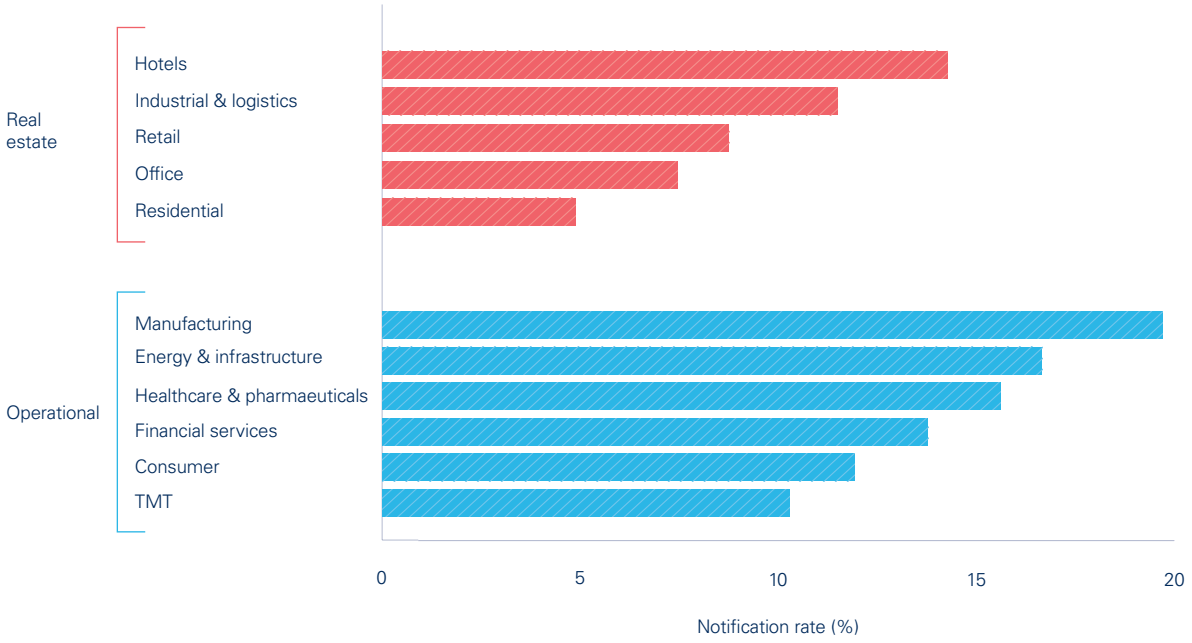


The difference in notification rates between certain jurisdictions is stark, but on balance has not driven underwriting behaviour. Whilst it is true that fewer insurers compete for Italian deals, so cover is generally narrower and pricing a little higher when compared with other Western or Northern European transactions, the same cannot be said for other jurisdictions where notification rates differ.

Over the past few years, French, Spanish, Dutch and German pricing and cover have converged with what is typically seen on Nordic deals but the data suggests that this situation will not be tenable in the long term, with notification rates in those jursidictions nearly three times higher than their Northern European counterparts. In time we would expect to see a cover or pricing correction that reflects the claims data.

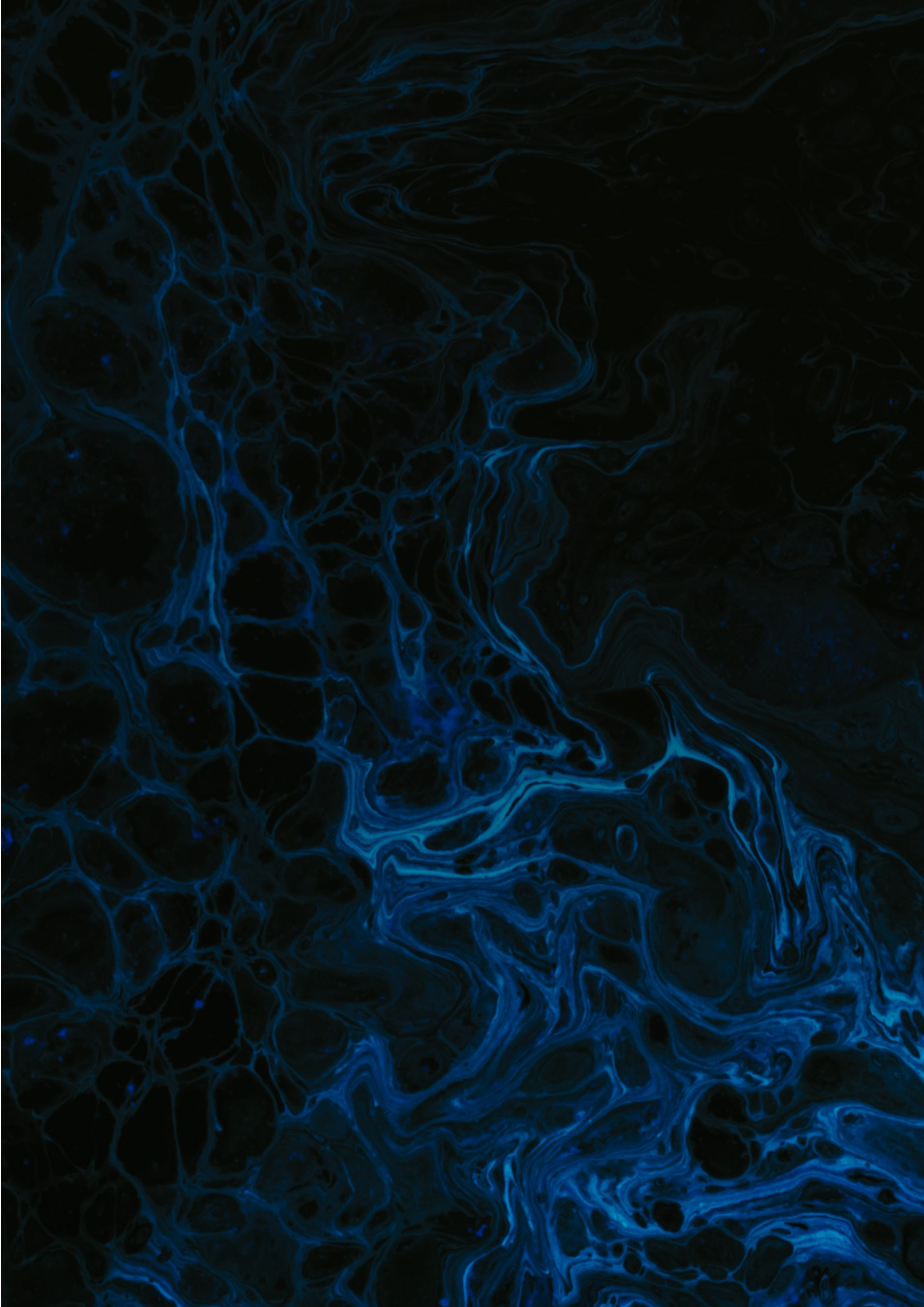
UK and Nordic deals boast relatively low notification rates, but this only tells half the story. Two of the largest claims paid in Europe in 2019 were attributable to UK and Nordic deals. Whilst there is generally a correlation between notification rates and severity of associated loss, it is not always the case, and even jurisdictions with limited claims history can see insurers suffer material losses.

Notification rates vary across industry sectors too



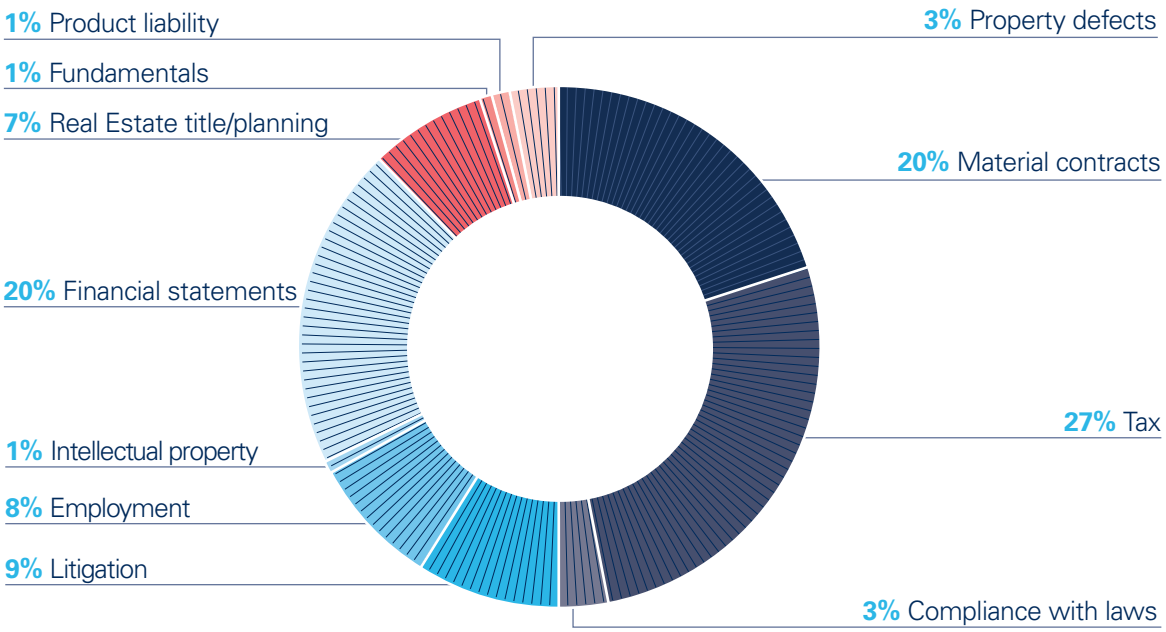
Notification rates are substantially higher on operational deals compared with real estate deals, supporting the broad market position of applying higher premium rates to operational transactions. However, there is an overlap, with industrial & logistics deals generating higher rates of notifications than TMT transactions, despite commanding a 30-50% lower premium rate per deal. Hotel transactions (including operational hotel companies) generated a higher notification rate than financial services transactions, a sector that many insurers have shied away from due to the perceived complexity and risk surrounding regulated businesses. Conversely, manufacturing transactions, favoured by many insurers, generated the highest notification rate of any sector.

This data supports the notion that insurer competition and perceived risk rather than claims data still drives pricing (and indeed retentions) in the M&A insurance market. Whilst this will not change overnight, as insurer data pools become larger and more insightful, there will surely be a shift towards data-driven pricing.



Section 2: Breach events

Commonly breached warranties



Another consistent trend seen across EMEA is that financial statements and tax warranties are the most commonly notified warranty breaches. This is unsurprising given that: (i) tax authorities regularly audit companies, actively searching for underpayments of tax; and (ii) a wide array of underlying breach events also result in the accounts being incorrect. Sophisticated buyers of insurance will also seek to claim under accounts warranties as it is often considered easier to tie the associated loss to a purchase price reduction, in turn allowing the insured to claim for a greater amount.

Howden M&A data reflects this trend, with 47% of all breaches stemming from financial statements and tax warranties, but clearly many other issues arise post completion. Breaches of material contracts, litigation and employment warranties are also regularly notified, together constituting 37% of all notifications. Material contract warranty breaches in particular often stem from non-disclosed disputes with suppliers or customers, and can result in material losses, especially for targets where income is weighted towards a limited number of customer contracts.

In focus: non-disclosure of material contract disputes

Howden M&A undertook an analysis of all notifications across the last five years with a >$10m quantum. The findings demonstrated that 30% of the underlying warranty breaches for these notifications stemmed from non-disclosure of material customer contract disputes. Anecdotal evidence from insurers supports these findings too, with several of the large claims paid in 2019 stemming from such breaches. Insureds typically claimed for a reduction of purchase price, multiplying the EBITDA generated by the customer contract in question by the purchase price multiple. Whilst insurers often disputed this methodology, the losses remained substantial.

During the investigation of these claims, it became apparent that in some cases there was clear evidence of sellers and/or management withholding information and/or wilfully misrepresenting. In these cases, buy side W&I insurance is designed to respond, with the insurer assuming any subrogation rights the buyer may have against the seller. In other cases, it was not clear whether the warrantors and/or the wider seller's knowledge group were aware of the underlying dispute, and whilst again, the policy is designed to respond, the insurer's ability to recoup funds is limited. This is especially the case for non-UK transactions with a private equity seller, where the selling vehicle (as opposed to management) frequently provides the business warranties, but relies on management for the broader disclosure exercise.

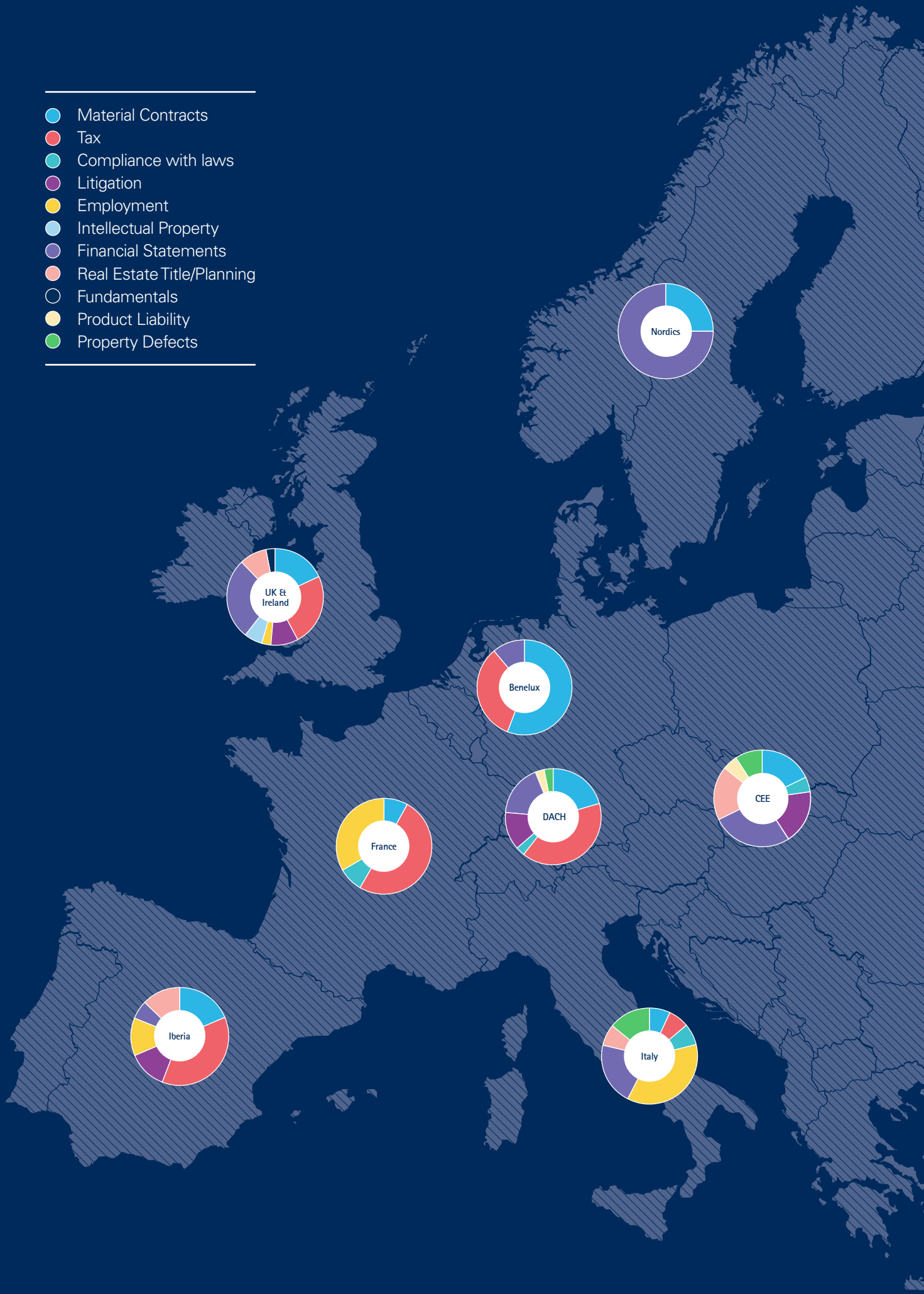
These claims highlight how even the most thorough diligence processes can fail to unearth all issues a target is facing and that adequate warranty protection (either from sellers/management or a W&I insurer) should be considered by purchasers on all deals, irrespective of how comfortable they feel following diligence. Insurers will also start paying closer attention to the material contracts diligence, in particular customer contract profiling, Q&A with sellers surrounding any ongoing disputes and whether buyers were able to hold customer calls ahead of signing.

The most commonly breached warranties differ across jurisdictions

In many ways the data reflects what one would expect: Germany and France experience a disproportionately high volume of tax notifications, driven by the active nature of their tax authorities and complex tax legislation; Italy and France generate high volumes of employment based notifications, in line with the employee-friendly legislation in those jurisdictions; and the UK, the jurisdiction with the highest volume of policies placed, exhibits the most diverse array of warranty breaches.

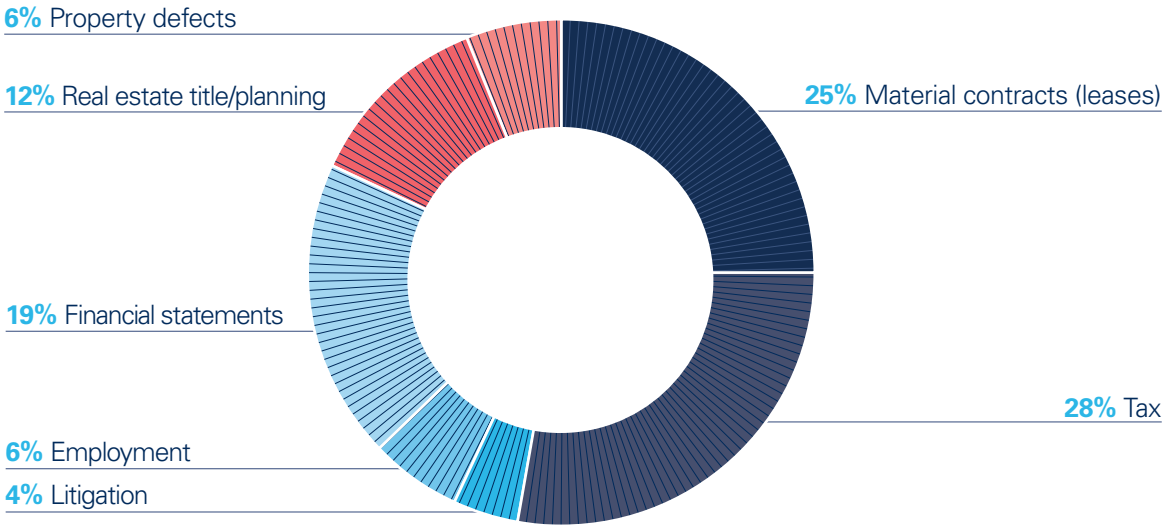
However, there are some surprises, e.g. a high proportion of Dutch notifications arise from tax breaches despite the relatively benign nature of the Dutch tax authorities, and a limited number of Italian tax claims despite serious concerns amongst insurers as to the approach of the Italian tax authorities. Intellectual property, product liability and cyber claims are also extremely rare, despite many insurers taking a conservative approach with respect to covering such warranties. It is only a matter of time before insurers start applying claims data in a more meaningful way during underwriting, and the first mover advantage will be substantial.

- Material Contracts
- Tax
- Compliance with laws
- Litigation
- Employment
- Intellectual Property
- Financial Statements
- Real Estate Title/Planning
- Fundamentals
- Product Liability
- Property Defects

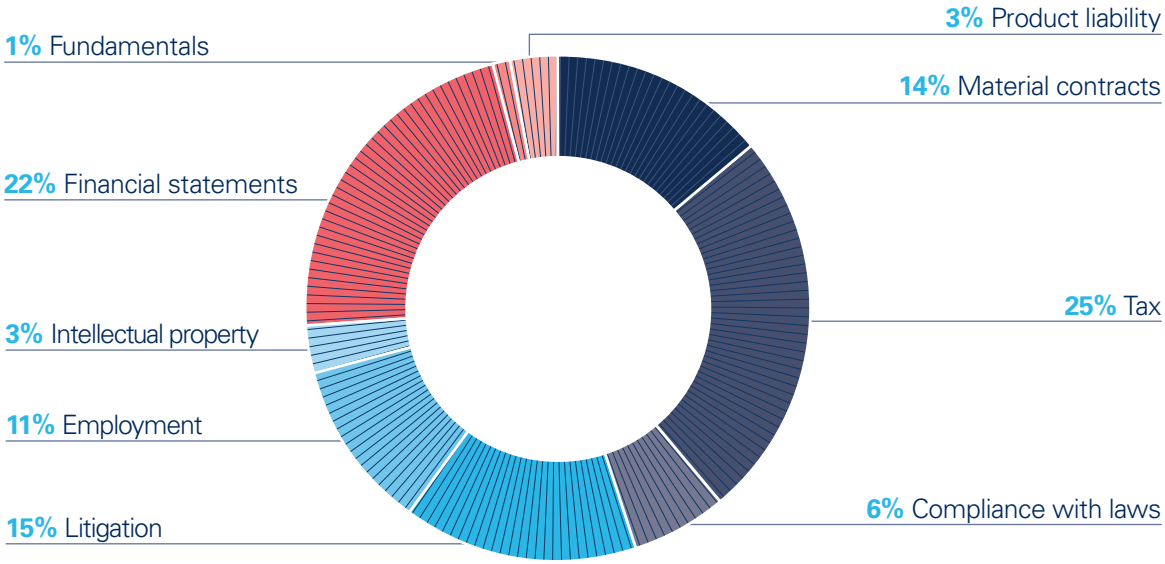


Warranty breaches differ between real estate and operational deals too

Commonly breached warranties on real estate deals



Commonly breached warranties on operational deals



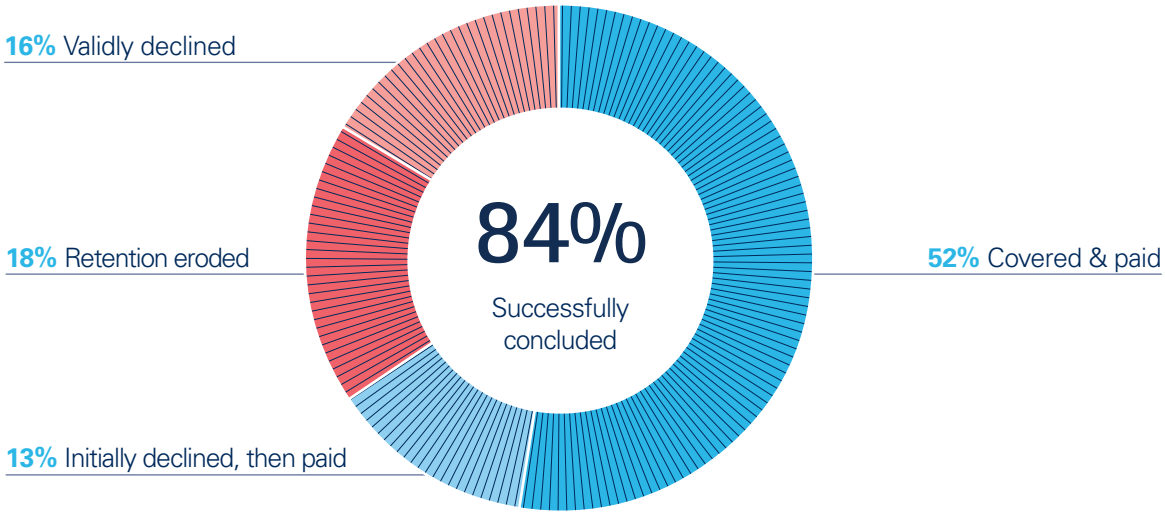
Warranty breach analysis

Whilst there is a striking similarity in the proportion of financial statements and tax warranty breaches across real estate and operational deals, other warranty breaches differ substantially. 25% of notifications on real estate transactions arise from material contracts breaches, compared with 14% on operational transactions. This makes it the second most commonly breached warranty for real estate deals, sitting between tax and financial statements. Given the number of leases and lease amends involved on real estate transactions, particularly on larger portfolio deals, it is unsurprising that issues are occasionally missed during diligence and warranty protection is required.

Notifications on operational transactions show that, alongside financial statements and tax, litigation, employment and material contracts warranties are commonly breached. A broader array of breaches also arise on operational transactions, driven in large part by the more complex nature of the underlying businesses. Again, the findings here are unsurprising and reflect the fact that operational transactions have many "moving parts" which make them challenging to diligence and often result in issues only being identified post completion.

Section 3: Payment of claims

Most claims conclude with a payment

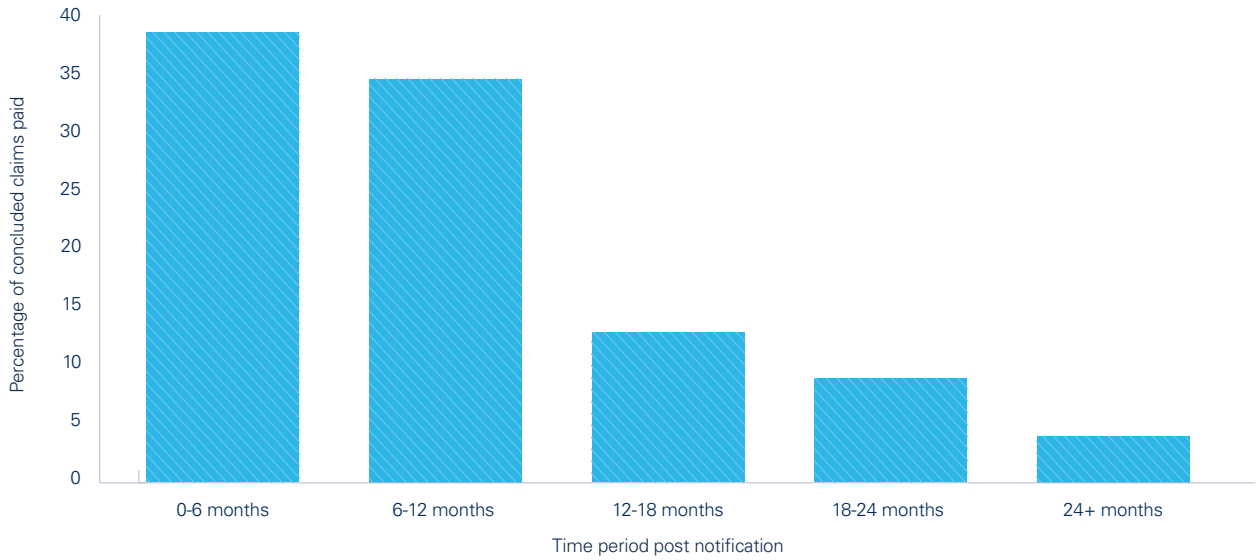


Our claims data demonstrates that W&I insurance works. 84% of Howden M&A's concluded claims resulted in either a claim being paid or, where the quantum did not exceed the policy retention, the retention being eroded. Insurers initially declined 13% of claims, many due to insufficient evidence showing that a warranty had been breached, but eventually paid. In these cases, we worked with our clients to identify evidence demonstrating a breach of warranty had occurred and the associated loss. Consequently, these policies responded.

Cover often turns on the interpretation of clauses in the policy wording or sale and purchase agreement relevant to the claim. Our experience shows that insurers usually take a pragmatic approach to differences in opinion, provided sufficient evidence is submitted to support the claim. Insurers also prefer to avoid litigation or arbitration costs and the inherent associated risks, so will often look to offer commercial settlements for contentious claims.

Insurers have validly declined 16% of our clients' claims. This is discussed below under 'reasons for declinature' on page 20.

Payments of concluded claims are typically made within 12 months of notification



Our claims data shows that insurers make payments quickly. 74% of concluded claims were paid within 12 months of the notification date and only 4% were paid 24 months after notification. It is crucial for insureds to be aware of and understand:

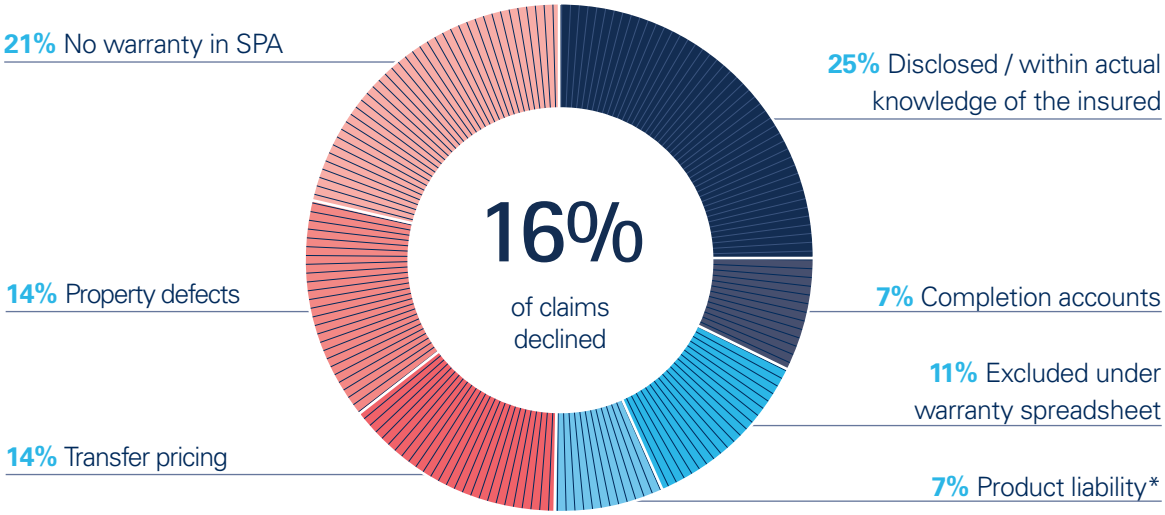
1. That insurers will investigate a claim to verify that it falls within the scope of policy cover; and
2. The steps required to evidence a loss and maximise recoverable amounts under a W&I policy.

A successful W&I claim will result in timely payment when insurers' claims managers receive evidence of: (i) the breach event; and (ii) the quantum of loss caused by that breach, aligning with the definition of "Loss" in the policy. An insured can ensure the claims process maintains momentum by promptly responding to the insurer's questions and facilitating the insurer's verification of the claim. Delays in securing payments almost always surround a lack of evidence, in particular with respect to calculating quantum, which is usually the most challenging element of the claim to substantiate as it requires production of the valuation model and a detailed explanation as to how it is impacted by the warranty breach.

Whilst a small number of insurers ask for more information than may be necessary to verify a claim, in our experience most insurers wish to complete the claims process as quickly and smoothly as possible. For more complex claims, ascertaining quantum usually involves the insurer, and sometimes the insured, engaging a forensic accountant to opine on the loss. Well-negotiated policies usually provide insureds with cost-cover to engage such advisers.

The economic impact of the COVID-19 pandemic is likely to impact drivers behind claims resolution. We are already seeing evidence of cash-strapped insureds accepting settlement offers from insurers that are lower than what they could secure if their appetite for negotiation was not outweighed by cash flow needs. Some insurers will be mindful of this on contentious claims, emphasising the importance of insureds receiving adequate advice during a claim, and producing detailed evidence in the early stages.

Reasons for declinatures



**only excluded on manufacturing deals where the target did not hold a product liability policy*

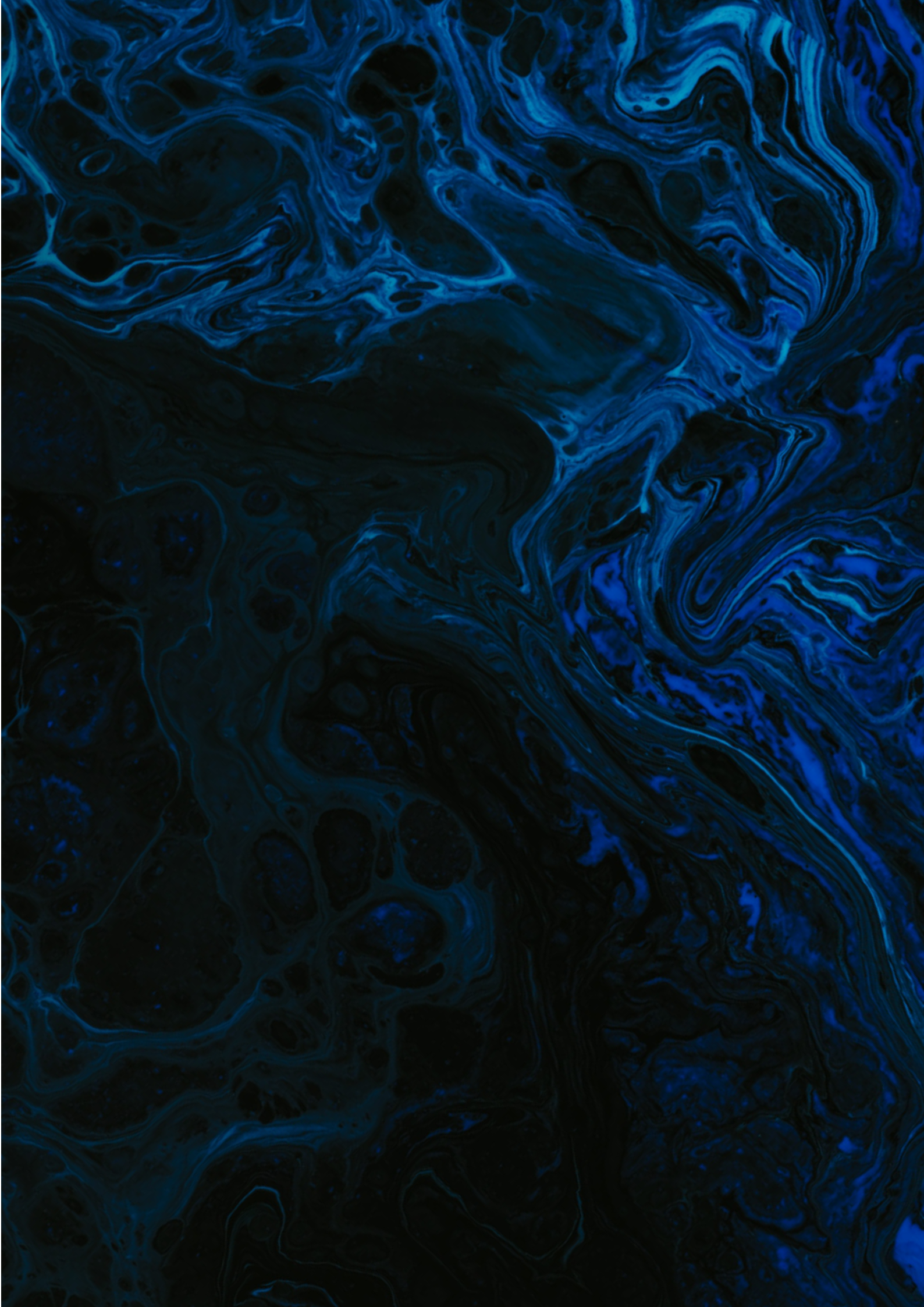
16% of our concluded claims were validly declined by insurers, with the position accepted by the insureds. It is usually clear from the outset when a claim validly falls outside the scope of cover.

The most frequent reason for declinature is that the underlying breach event was fairly disclosed, usually in the diligence reports and less often in the data room. Incidentally, this reason for declinature is also the one we have had most success in overturning (see "initially declined then paid" on the chart on page 18). It is critical that the definition of "Fairly Disclosed" in the policy is sufficiently narrow to limit the insurer's ability to utilise this exclusion. If the policy allows for an enhanced definition of "Fairly Disclosed", it is also key to disregard the SPA definition to avoid a double standard applying. Given the above, Howden M&A's view is that all insureds should seriously consider paying the 5-10% additional premium to remove the disclosure of diligence reports exclusion from the policy, an enhancement many insurers now offer.

Other exclusions are also a major reason for declining claims, with 46% of validly declined claims arising from matters that insurers have specifically stated will not be covered under the policy. In particular, transfer pricing and property defects exclusions, standard across the majority of W&I policies, have proved useful to insurers, with 28% of our validly declined claims arising from these matters.

It is worth noting that buyers had other means of recourse for approximately 10% of validly declined claims. For example 4% of claims were declined on the basis that a specific indemnity covering the issue at hand was included within the SPA. In these cases insureds submitted notifications as a precaution, but were not expecting the policy to cover their loss in the first instance.

Many insurers are including COVID-19 exclusions in their policies in response to the COVID-19 pandemic. In some policies, the drafting is extremely broad, substantially narrowing the scope of cover. Buyers and their brokers should pre-negotiate the COVID-19 exclusion with insurers prior to proceeding to full underwriting. We have a detailed guidance note on how to deal with this in the context of a deal and can share this on request.



Section 4: Case studies

Case study 1 - UK tech business: software licencing shortfall

THE CLAIM

The insured purchased a payment processing business. The seller failed to disclose that the target was operating with a shortfall in Microsoft software licencing. This shortfall meant that intellectual property, critical to the target's operations, was being used without a licence, in breach of warranty.

The insured sought cover for the cost of obtaining the missing licences, subject to an EBITDA multiple.

INITIAL DECLINATURE

The insurer challenged cover on the basis that the insured had not provided sufficient evidence:

a. showing a licencing shortfall as only a summary of a contract with Microsoft had been provided which did not identify the group companies it related to;

b. that the cost accrued for licencing in the accounts did not include the alleged shortfall; and

c. justifying the EBITDA multiple applied to the cost to obtain licences for the shortfall.

SUCCESSFUL OUTCOME

The claim was resolved by a two stage approach, for a sum acceptable to both parties:

a. Howden M&A secured confirmation of a warranty breach after submitting emails setting out the licencing arrangements, obtained from the target's IT director; and

b. discussions between the insurer's forensic accountant and the relevant individuals with knowledge of the target's IT and accounting systems resolved any uncertainties relating to the accrual in the accounts. Provision of contemporaneous evidence of the business valuation and in particular, the EBITDA multiple applied supported the loss calculation.

This claim demonstrates the importance of making records in the course of a transaction evidencing the rationale for the valuation used.

Case study 2 - German real estate portfolio: non-disclosure of a lease extension

THE CLAIM

The seller failed to disclose that the target had agreed to extend the terms of an existing lease for several years at below market rate rent. The information disclosed about the lease recorded that it terminated within months of closing.

The buyer argued that multiple warranties were breached including that the seller knew an annex of lease information was inaccurate.

The insured sought cover for the difference between the fair market rent and the rent in the lease extension.

INITIAL DECLINATURE

The insurer initially declined the claim, alleging:

a. There was no warranty breach because the insured had not evidenced that the seller was aware that the annex of lease information was incomplete; and

b. The amount of loss claimed was not sufficiently evidenced.

SUCCESSFUL OUTCOME

Howden M&A worked with the insured to secure sufficient evidence that the seller was aware of the lease extension.

The insured acknowledged there were gaps in its quantum evidence and accepted a settlement amount which reflected this.

This claim shows that insurers will take a pragmatic approach to settlements where the evidence of a breach is clear, even if the evidence of quantum is not "gold standard".

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Our team of 70 individuals, with backgrounds in law, investment banking, accountancy, tax, environmental engineering and underwriting provide clear and structured advice on how best to implement the array of M&A insurance products available on transactions and secure claims payments on behalf of our clients.

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