

PERFECT INSURANCE STORM? FINALLY ADDING REAL VALUE

In the last edition of our newsletter at the end of 2009, we shared our view that the M&A market in general and the private equity market in particular were starting to recover from the terrible downturn of late 2008 and early 2009. That may have been true, and it is fair to say Willis M&A was busier in Q1 of 2010 than we had been for many quarters. However, it is perhaps only a reflection of how far the market had fallen from its peak rather than a real sign of a robust return to health. Our activity levels may also be more of a barometer of risk aversion than purely deal volume related. Given that we focus on providing insurance products and advice during an M&A transaction, and that insurance is a core part of managing risk, perhaps we are benefitting from a general change in people's attitude to risk. That being said, we have continued to see transactions close during 2010 where no formal insurance due diligence was completed, or indeed requested, by the financing banks. Whilst we would never wish for our clients to undertake unnecessary work during the intense pre-investment process, we remain hugely surprised whenever we see a deal close without some form of formal insurance advice being provided. At the very least, we will provide an extra layer of comfort and at the most, we can identify real issues that could destroy the entire basis of your investment. More often than not there are issues which at the very least go directly to value.

The most exciting pattern to emerge during the first half of 2010 has been the significant increase in both the enquiry level and conversion rate for transactional liability insurance (including Warranty & Indemnity/Representations & Warranties insurance, Tax Liability insurance, Environmental insurance and bespoke policies for other contingent liability deal exposures). As the title of this introduction suggests, we believe that there are a number of contributory factors in driving this sector including:

- the general increase in risk aversion
- the maturing of the insurance underwriting community, particularly in London (the traditional home of these products)
- significant increase in insurer competition, which in turn has resulted in
- material reduction in premium rates and excess levels (attachment points) and
- real enhancement of policy wordings.

The statistics below demonstrate these points:

Average premium rate 2008 – 1.8% (U.K. to U.K. transactions)

Average premium rate 2009 – 1.85%

Average premium rate to end of April 2010 (four months) – 1.01%

In addition, the placement volumes (enquiries v placements) have increased:

2009 – 175 enquiries/placements 24

To end of April 2010 (four months) – 101 enquiries/placements 21

The new markets this year alone include two Lloyd's syndicates (Pembroke and Beazley) and Houston Casualty Company (HCC) bringing us to nine lead markets in all in London. The others are Chartis (formerly AIG), Zurich, Ambridge, Chubb, AWAC and ACE.

The ability of these products to provide a genuine alternative to other methods of pricing risk, or of protecting against crystallisation of risk in a transaction is significant. We are regularly seeing the real benefits to parties on both sides of transactions of pursuing an insurance solution as opposed to price chipping, seeking contractual SPA recourse, escrows, or deferring consideration. We are seeing the products used by vendors in a 'staple' manner and by buyers as a strategic differentiator in competitive bidding processes as well as to satisfy recourse requirements imposed by financing banks. In addition, the introduction of an insurance contract can materially enhance the ability of a vendor to distribute unencumbered sale proceeds to investors and shareholders.

Given the value associated with transactional insurance products across the entire M&A sector, we have dedicated this edition of the Willis M&A Index to this topic and the following pages include a detailed overview of the products and the market place written by the leader of our international Transaction Solutions team, Brian Hendry. In closing we are excited about the maturing of this area, particularly in Western Europe, and look forward to replicating the success of the products in other parts of the world, particularly North America (where awareness and utilisation is materially lower than Europe) and emerging markets such as those in Asia and Latin America.

Please do not hesitate to contact your local Willis office or M&A representative if there are any issues which you would like to discuss in more detail.

Alistair Lester, International Practice Leader, Willis M&A.

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WARRANTY AND INDEMNITY INSURANCE

INTRODUCTION

Warranty & Indemnity insurance (W&I) (and other forms of transaction insurance) assists the parties to an M&A transaction in three key areas: (i) to realign potentially 'deal breaking' issues; (ii) to secure an additional layer of financial security; and (iii) to transfer contractual risk encapsulated within a Sale Purchase Agreement (SPA) to a third party insurance company.

The W&I policy is an insurance contract that is arranged on behalf of an insured (either the buyer or seller/warrantor of the target) to meet the specific contractual requirements of the M&A transaction that the parties are negotiating.

WHAT DOES IT COVER?

A W&I policy insures the warranty and in certain cases indemnity, risks contractually created between a seller/warrantor and buyer within an SPA. Under a standard English Law SPA this should also include cover for the tax covenant/deed. If following completion of an M&A transaction there is a breach of warranty (or indemnity), the insured party will have the ability to claim directly against their W&I policy. If the seller/warrantor is the insured (seller-side policy) W&I policy is designed to support them in the defence/pay on their behalf, as a result of a claim made by the buyer. Alternatively, if the buyer is the insured (buyer-side policy), the buyer may claim directly against the policy for the loss they sustain, as covered in the W&I insurance. For the above and other reasons, if the policy is going to work efficiently it is important to have a good understanding of the policy structure and terms required, as the correct policy structure will significantly enhance a party's objectives.

WHAT DOES IT NOT COVER?

The policy can not replace the disclosure, due diligence and contract negotiation process that is key to a good transaction. W&I insurance relies on the sellers and buyers undertaking a thorough negotiation – as they would if insurance was not being provided. If underwriters consider that the disclosure or due diligence process has not been robustly carried out, or certain warranties have been agreed with language that is too broad in the context of the transaction, an underwriter may restrict, or ultimately not offer cover.

As a general rule, known risk is not insured as it is expected that the seller and buyer will have dealt with such issues on the transaction negotiation table.

HOW DO INSURANCE WORDINGS DIFFER?

With a growing market of active insurers there are now a number of different wordings available. Generally the policies are divided into common sections and a certain number of the insurers use similar base wordings.

Over the past five years the market has positively welcomed significant development and improvement (from an insured's perspective) to their policy wordings, which has led to the terms and conditions being clearer and easier to understand.

While W&I is an insurance it is also a contract that is open to negotiation. Careful consideration should be paid to drafting the wording, particularly the exclusions and conditions, to ensure there is no mismatch with the transaction SPA.

WHAT ARE THE TYPICAL EXCLUSIONS?

Over the past few years the W&I policy has seen significant developments and improvements including a reduction in the standard exclusions. While the various insurer policy forms vary, common exclusions include:

- Forward looking warranties
- Breach of warranty actually known by the insured at inception of cover
- Fines and Penalties (uninsurable at law)
- Fraud or fraudulent misrepresentation by the insured

Subject to the particulars of a transaction, additional exclusions may be requested by the underwriters.

WHAT LIMITS ARE AVAILABLE/TYPICALLY PURCHASED?

The limit of cover purchased by an insured is unique to their particular risk appetite and varies dependent upon the deal scenario. On a very general basis, policy limits equivalent to 25% – 50% of the enterprise value of the transaction are arranged by financial investors.

A seller-side policy can insure the full limit of liability agreed in the SPA plus defence and investigation costs, or a lesser amount where the insured is willing to bear the remainder of the risk. It should be noted that the costs incurred in defending or investigating a claim covered under the policy will diminish the limit available for potential damages.

Under a buyer-side policy, the insured has the ability to select the limit of cover which provides them with the appropriate level of comfort that they want.

If required for a single project, insurance limits of between GBP 200 – 250 million can be sourced from the market on a syndicated basis. Policy limits from a single insurer range between GBP 15 million and GBP 35 million.

PREMIUM CASE STUDY INDICATIONS

Due to a number of converging factors but primarily increased competition, the U.K. W&I market is now more competitive than it has ever been. Premium rates for U.K. transactions can regularly be obtained in the region of 1% of the policy limit purchased i.e. a GBP 10 million policy limit produces a premium for the entire policy period of GBP 100,000 + applicable insurance premium taxes.

Minimum levels of premium, typically GBP 12,500 to GBP 25,000 will apply if the level of cover is GBP 2,000,000 or less.

Factors that will influence the rate include the nature of the target business, the enterprise value compared to the policy limit and the policy retention (excess) that is required.

WHAT IS THE TYPICAL LENGTH OF THE POLICY?

The policy period is designed to mirror the periods agreed within the SPA – e.g. 12/18/24 months for non tax warranties and seven years for tax (inc. Deed/Covenant).

Within the context of a buyer-side policy, it is possible to extend the policy period beyond the limits agreed in the underlying SPA e.g. if sellers give a maximum of 12 months for the entire warranty suite, the W&I policy could give 24 months/7 years for non tax/tax.

IS THERE A SIGNIFICANT PREMIUM VARIATION FOR DIFFERENT GEOGRAPHIES?

The market for U.K. business remains the most competitive, but as insurers compete for new business, the premium rates for the ‘attractive’ projects in traditionally more ‘risky’ markets – USA, Central and Eastern Europe and Asia/Pacific – have been reducing.

WHAT SHOULD BUYERS LOOK OUT FOR?

Like any product it is important to understand the market, be up-to-date with the recent developments and close to changes that are being made. W&I is a very niche insurance product and few brokers have specialists that truly understand the market. It is worth searching out experts who can guide you through the underwriting process and ensure the cover provided is as competitive and full as possible.

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WHO OFFERS THIS TYPE OF INSURANCE?

Within the London market there are three major specialist insurance broking teams and nine specialist insurance providers:

Ace, Ambridge, AWAC, Beazley, Chartis, Chubb, HCC, Pembroke, Zurich

NOTABLE CLAIMS

Due to the relatively young life of W&I insurance as a product, particularly in certain territories, coupled with the confidential and sensitive nature of claims, obtaining details is limited.

It is known that a number of seven figure payments have been made and that the claims activity has increased over the past 18 months. Experience shows that most claims made under insurance policies have stemmed from third party claims or actions which neither party anticipated. The claims experience of the market shows that claims tend to occur either after the first audit, or when there has been a significant change in management. Often, the first notification is made under the warranty relating to business since the accounts date or the management accounts warranties, but following investigation, more typically, will fall under the more specific areas of risk.

If during a transaction you were told that almost the entire warranty and tax deed liability could be transferred to an established financial institution for a reasonable single payment, you would have to ask, ‘Why wouldn’t I do this?’

In the 2010 M&A environment where there is a greater need than ever to research, identify and assess risk and look for a strong counter-party to back that risk, the ability to transfer significant portions of contingent transaction liability, at a reasonable cost, needs to be given serious consideration. Transaction insurance can enable investors to unlock real value when exiting or acquiring a target business and due to an alignment of various factors, the transaction insurance marketplace is now more competitive and commercial in its outlook than it has ever been.

Willis Mergers & Acquisitions Practice provided Transaction Advisory Services on the

Acquisition of

Howie Group Limited



by

BSW Sawmills Limited



November 2009

This announcement appears as a matter of record only

Willis Mergers & Acquisitions Practice provided Vendor Due Diligence Advisory Services on the

Sale of the Survitec Group



by




January 2010

This announcement appears as a matter of record only

Willis Mergers & Acquisitions Practice performed the Insurance Due Diligence for the


Acquisition of

Polichimica SAP Farmaceutici S.p.A.



by

Euticals S.p.A.




March 2010

This announcement appears as a matter of record only

Willis Mergers & Acquisitions Practice provided Insurance Due Diligence Advisory Services on the

GBP 217 million transaction to acquire Eggborough Power Limited



On behalf of

The Eggborough CTA Bondholders


March 2010

This announcement appears as a matter of record only

Willis Mergers & Acquisitions Practice provided Insurance Due Diligence Services on the


Substantial equity investment into

Vertical Pharma Resources Limited



by

Elysian Capital LLP



April 2010

This announcement appears as a matter of record only

Willis Mergers & Acquisitions Practice provided Insurance Due Diligence Services on the

Acquisition of



by




April 2010

This announcement appears as a matter of record only


Willis Mergers & Acquisitions Practice performed the insurance due diligence for the

Sale and Leaseback of

BancoSabadell



by



May 2010

This announcement appears as a matter of record only

Willis Mergers & Acquisitions Practice performed the insurance due diligence for the

Equity Investment in



by



May 2010

This announcement appears as a matter of record only

Willis Mergers & Acquisitions Practice performed insurance due diligence and structured buyer side Warranty & Indemnity insurance on the

Acquisition of



by



May 2010

This announcement appears as a matter of record only

Willis Mergers & Acquisitions Practice provided Insurance Due Diligence Services on the

Investment into



by



May 2010

This announcement appears as a matter of record only

Willis Mergers & Acquisitions Practice performed the insurance due diligence for the acquisition of



by



From




May 2010


This announcement appears as a matter of record only

Willis Mergers & Acquisitions Practice performed the insurance due diligence for the

Refinancing of



by



June 2010

This announcement appears as a matter of record only

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