Aon Risk Solutions
Aon M&A and Transaction Solutions

Mergers & Acquisitions Insurance Market Update

Empower Results®

Mergers & Acquisitions Insurance Market Update

Overview

- 2017 was the largest year for Aon in warranty & indemnity (W&I) insurance to date, in Australia and globally, and all indicators predict that 2018 will maintain this momentum.
- Growth of new insurers means more insurance capital is available than ever before – which in turn means more competition between insurers to win deals and the ability to insure larger deals.
- More capacity has also meant excess pricing rates have plummeted; primary rates have remained steady albeit certainly at the low end of the range.
- Buyer's market for W&I – good for corporate clients who are increasingly using the product and Private Equity (PE) exits and acquisitions.

State of the market

Growing market; cheaper premiums

As the uptake of W&I insurance on deals increases globally, by corporate and PE clients, W&I insurance is a growing and competitive marketplace. New and increasingly aggressive insurers in the Australasian region have driven a number of overall market trends in the 2017 year – all 'client friendly':

- Excess pricing has plummeted meaning the cost of insurance for larger deals, or where a programme of insurance is required, is more cost effective than ever.
- The drop in excess pricing coupled with primary rates remaining low and stable, has meant that average premium rates in 2017 for the first time dropped below 1% of the limit insured.

Competitive terms and lower retentions

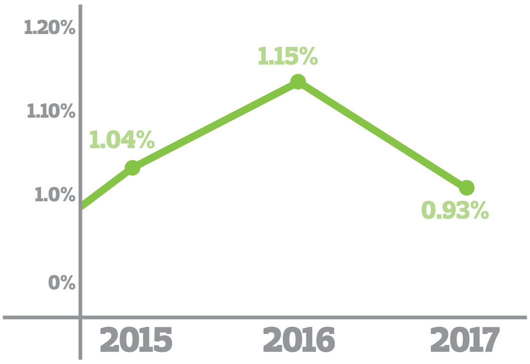
Another sign of a current competitive market is that while average premium rates are decreasing, the policy terms offered by insurers are becoming more favourable. For example, tipping retentions or deductibles were offered and purchased on almost half of Aon deals placed in 2017. Retentions that tip all the way to nil, such that there is recovery from the first $ of loss, are back on the table from certain insurers and the ability to offer a lower than standard 1% retention is offered regularly by most markets. These 'enhanced' retention options are dropping the average retention lower for 2017 than prior years.

Over $1 billion of insurance capital - larger insurance programmes

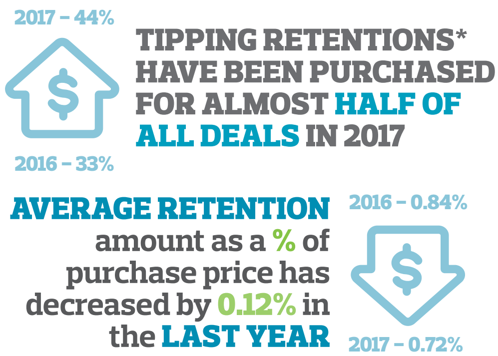
Larger deals are being insured as the product becomes more penetrated in the market. First or second round PE acquisitions are now sizeable, making large successful exits where W&I insurance is required to protect the exiting PE fund. While benchmarking indicates that the larger the deal, the lower % of limit insured, the fact there are more and more circa $1 billion plus deals being insured, means that regularly programmes of $100 million plus are being structured. As a result, the average amount of insurance per deal underwritten by the market increased from circa $30 million in 2016 to close to $65million on average in 2017. New and old market entrants all want a slice of this pie. There is now well over $1 billion of capital available to support any one deal.

Premium movement

premium rates have decreased in 2017 due to excess rates plummeting and larger programmes being placed bring cost of insurance down

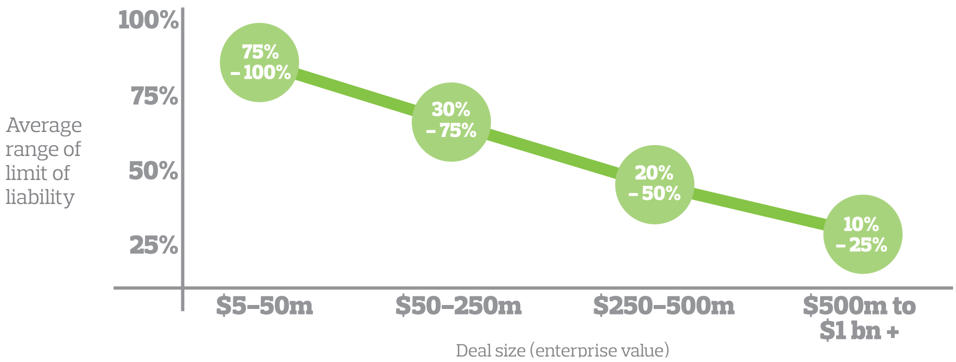


Retention/deductible trends



* Retention or deductible that reduces to some lower amount (typically 50% of original amount) once that retention has been satisfied.

Benchmarked limits of liability by deal size



Aon broking innovation provides distinct advantage

The use of Aon Client Treaty (ACT) on large or complex placements gives Aon clients a distinct advantage especially given the increased number of programme deals and need for excess capacity. This allows Aon to achieve the most efficient pricing with market leading coverage.

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

Coverage trends - what to watch for

Coverage and underwriting appetite remains largely unchanged across the market despite the aggressive pricing dynamics. The most prevalent position in the Australian market still remains that W&I insurance can offer a 'nil recourse' position to sellers without requiring 'seller-skin' in the game through any form of escrow or hold back (unlike the US market for example). Key underwriting focus areas remain the same as per prior years, with a heavier focus on cyber risk being predicted for the next 12 months. The underwriting process remains rigorous; however some commentary suggests that this may be a by-product of cheaper pricing and lower retentions. It will remain to be seen in 2018 whether there is a trend from clients and insurers alike back towards more 'standard' policy metrics; or slightly higher pricing to facilitate a more seamless underwrite and coverage position.

Key areas of underwriting scrutiny

- Secondary tax liability/ transfer pricing
- Underfunded pension plans
- Structural defects
- Environmental contamination
- Professional indemnity
- Anti-money laundering/ anti-bribery
- Product recall
- Cyber Risk

Aon Client Treaty

Characteristics of the treaty

20% unique co-insurance capacity

Pre-secured capacity

- Automatic pre-secured co-insurance capacity of 20% of any order placed in the London market through the Aon's Global Broking Centre (GBC)
- Applies to annual and most multi-year client contracts incepting on or after 1 January 2016
- Applies to business placed through the GBC in London

Lloyd's infrastructure

Established process

- Capacity secured exclusively from Lloyd's syndicates
- Highly efficient claims agreement and settlement via the Lloyd's Claims Scheme
- A+ rated paper, backed by the Lloyd's Chain of Security

Extensive eligibility for clients

Global scope

- Every industry segment underwritten in the London market, other than nuclear risks
- Every class of insurance underwritten in the London market, other than political risk, trade credit, and certain minor exceptions
- Every geography underwritten in the London market where Lloyd's is licensed to do business

Automatic follow-form

Consistent coverage

- Automatically follows the pricing, wording, terms and conditions of the lead underwriter for the London order

Looking ahead – trends for 2018 and beyond

Warranty and indemnity insurance not just for private deals

To dispel a common myth - W&I insurance is no longer just a solution for private deals, but can be put in place on public deals where the deal is to be by way of Scheme of Arrangement. This evolution of W&I insurance to the public sphere provides a solution to facilitate the provision of meaningful warranties to the buyer in a Scheme transaction. The warranties and indemnities given by the Target under the Scheme document would need to be negotiated and subject to disclosure and customary qualifications and limitations akin to private deals, and if 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 otherwise largely similar to that of private deals – making a compelling consideration to adopting on more public deals where a buyer is seeking customary warranties.

US style cover

Leveraging our global reach, Aon has been successful in structuring US style cover for clients in the Australian market. In light of Aon's global reach, Aon Australia frequently acts for US buyers acquiring Australian companies. One of the key differences between Australian deals and US deals is the disclosure regime qualifying the warranties – Australian custom is to provide for a much more liberal disclosure regime to qualify the warranties, for example, Australian deals have disclosure against data room; US deals have disclosure against a disclosure letter. Where US style disclosure is adopted in an Australian purchase agreement, certain insurers are willing to offer full US style cover – i.e. no data room or buyer's due diligence report exclusion, materiality scrape against warranties, no de minimis or per claims threshold in policy and removal of warranty spreadsheet. This "US style" cover however comes at closer to US premium rates. Premium rates in the US typically range between 2% to 3.5% of the limit insured; whereas Australian pricing is typically 1% to 1.5% of the limit insured. This flexibility and ability to attain such cover is increasingly being elected by our US clients in Australia.

Non-negotiated warranties

Aon is working closely with our insurer partners and clients to innovate solutions where there are no (or limited) warranties in the underlying purchase agreement. The policy itself would contain a suite of warranties that are in turn insured. Aon is exploring how this structure may be able to be accommodated and underwritten on certain deals in Australia with the right profile (for significant additional premium cost).

Competitive auction processes and ability to accommodate multiple bidders

Approximately one-third of all of Aon's deals in 2017 originated as "seller-mandated" W&I processes, whereby Aon was engaged by the seller in a competitive auction scenario to structure the W&I insurance for the benefit of all bidders. Aon then 'flips' to work with the preferred bidder(s) to finalise and put in place the insurance for the winning bidder, allowing the seller to achieve a clean exit from the deal. In a competitive scenario, it is important that the insurance process has the ability to support multiple bidders in separate 'trees' and flip to more than one or two preferred bidders after the final bid date. In the last year Aon has been successful in working with the insurance markets to facilitate up to 4 bidder trees with the selected insurer, along with four independent Aon advisers, after the flip from the seller. Previously the market was only able to support a maximum of 2 bidder trees. Additional trees can come with additional fees (including legal and break fees); however for the overall auction process, this means more bids can be assessed and heightened competitive tension can be maintained up until the signing date.

Private Equity lifespan

A growing number of PE exits occurred over the past 3 to 5 years where the policy was put in place on their acquisition. Now with the time ripe to exit, consideration needs to be given on how to best deal and leverage the existing W&I policy. PE typically hold portfolio companies for circa 3-5 years (sometimes less). W&I policies generally have an operational warranty period of 2-3 years and a 7 year period for title and tax warranties and the tax indemnity, meaning the W&I policy put in place on acquisition is still on foot at the time of exit. Aon has successfully leveraged the existence of this original policy when putting the W&I in place on the new deal to the advantage of both the buyer and seller in terms of both cost and coverage. The structuring needs to be carefully considered in order to ensure no gaps in cover.

Uptake by corporate buyers globally

Aon's global W&I statistics show the take up by corporate clients of W&I insurance globally is increasing, with nearly one-third of all policies put in place last year being for corporate clients, up on prior years, whilst historically W&I insurance was the majority domain of private equity players.

Aon's Global M&A Insurance Track Record

96% Growth in the number of Aon transaction liability insurance policies written from 2014–2017

$27.2B Amount of Aon transaction liability insurance limits placed in 2017

54 Dedicated Aon Transaction Liability Solutions team members

34 Number of former practicing M&A, tax and litigation lawyers

#1 Transaction liability insurance industry leader by limit placed and policies written

#1 Tax insurance team by number of policies, limits placed and tax lawyers on staff

Contacts

Elissa Etheridge

Client Director
Aon M&A and Transaction Solutions
+61 2 9253 8108
elissa.etheridge@aon.com

Laura Gaynor

Client Manager
Aon M&A and Transaction Solutions
+61 2 9253 8125
laura.gaynor@aon.com

Sam Thomas

Client Manager
Aon M&A and Transaction Solutions
+61 2 9253 8452
sam.thomas@aon.com

Anita Vivekananda

Client Manager
Aon M&A and Transaction Solutions
+61 2 9253 8443
anita.vivekananda@aon.com

aon.com.au/m&a

About Aon

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