Insurance for M&A: A coming of age and an exciting future ahead.

Aon Inpoint

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Empower Results®

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Introduction

Aon has led the way in developing bespoke insurance solutions to meet the M&A industry's needs for the past 20 years. The volume of policies written, and the breadth of our client base coupled with the expertise and acumen of our global team, provide us with tremendous insight into market trends across industries and geographical regions.

For insurers interested in penetrating the growing marketplace for insurance products in the M&A space, Aon has a proven track record of adding value at every stage of the process. Aon has assisted c.40% of MGAs in the current market to find capacity in the Transaction Solutions space and has assisted insurers, reinsurers and consortia with their strategic plans.

Aon has invested in broad and deep expertise across the M&A arena. Aon's M&A and Transaction Solutions team has been instrumental in driving the market forward and continues to innovate to meet client needs. Having entered the marketplace for transaction-related insurance products in the 1990s, Aon has grown its market position to become a global frontrunner in the space; building dedicated teams, expediting the broking and placement process, enhancing coverage, building more insurance and reinsurance capacity, and articulating the benefits of transaction solutions products to its clients

"I am proud of the role that Aon has played both in the original creation of and now the rapid maturing of the insurance market for M&A transactions. However, we are committed to being part of defining the future path for this exciting risk class and ensuring that we sustain the material value that is generated for our clients and the insurance industry from these solutions"
Alistair Lester,
Aon M&A & Transaction Solutions

Aon Inpoint, the management consulting and advisory arm of Aon, works with (re)insurers, private equity, financial services providers and clients with interests in Property & Casualty, Health & Benefits, and the Life marketplace. We help clients capture high value opportunities and solve high impact problems on a diverse set of topics including market strategy, growth, distribution effectiveness, operational improvement, acquisition targeting, due diligence, and integration.

Being a complex and evolving marketplace, the insurance market for M&A transaction benefits hugely from a multi-disciplinary team. Aon Inpoint works seamlessly with Aon's M&A subject matter experts in the Transaction Solutions practice group and other areas of Aon, bringing together expertise from both the insurance world and from those with vast experience on the buy-side and sell-side of M&A activity. This includes underwriting and broking professionals, as well as those with backgrounds in finance, private equity, legal, investment banking and operations.

Aon Inpoint has recently helped a number of insurers to understand the opportunity in the M&A transaction space, answering questions such as:

- What are the dynamics of the marketplace?
- What are the market size and growth opportunities?
- How profitable is the market?
- What is the optimal strategy for an insurer to best enter the market?
- How can an insurer achieve growth?
- What is the future of the market? Is it sustainable?
- How will innovation affect the market?

This paper touches on some of these questions, with a particular focus on the EMEA region and the London Market.

I would like to express thanks to the individuals who have contributed to this document, notably my colleagues in Aon Inpoint: Jane Hemsworth, James Bradbury and Paul Bailey as well as the EMEA Transaction Solutions team: Alistair Lester, Simon Tesselment, Giulio Greco and their EMEA colleagues. We would also like to thank the insurers and Managing General Agents who provided valuable insights.

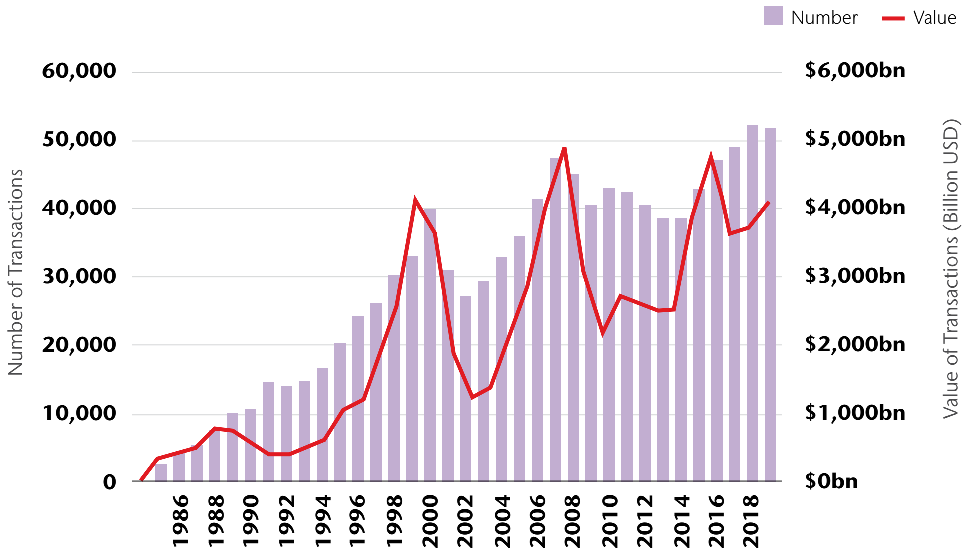
Rohan Dixon
CEO, Aon Inpoint

Introduction to the global M&A transaction environment

Merger and acquisition (M&A) activity has been strong and has been continuing to increase over the past couple of years, with increased deal flow and more active buyers and sellers in the marketplace. Whilst the 'megadeals' (more than $1bn) that grab the attention of the media have increased in volume and dollar value, activity has been robust across deals of all sizes.

Regardless of the deal size, the recent economic environment has been favourable for M&A activity. Interest rates remain low and PE firms have been flush with an abundance of capital to be invested. Meanwhile, company balance sheets are stronger than they have been in recent years, which means companies are looking at ways to deploy their excess capital.

Mergers & Acquisitions Worldwide



Source: Institute for Mergers, Acquisitions and Alliances (IMAA)

"We're in an extraordinary period of ultra-low rates and massive liquidity"

Harry Hampson, Chairman of the EMEA Industries Coverage group at JPMorgan, reported in "Return of mega-deals helps European M&A double", Reuters Business News, 29 June 2018

The single biggest driver for insurance products in the M&A marketplace is the economy. Much of the 'megadeal' activity is driven by the economy (as seen in the value of deals), but the volume of mid-size deals is more resilient to cyclical conditions. However, several other factors have positively influenced the uptake of insurance products, including more risk averse buyers, an increasingly seller friendly market, greater familiarity and acceptance of the products by the M&A community, an abundance of capacity and a relatively benign claims environment compared to other classes of business.

In the wake of the financial crisis, there was a significant decline in the global volume of transactions. Only in 2015 did the volume of deals recover to pre-recession values. Companies are now looking to rebuild, grow, and achieve economies of scale within an ecosystem that has an increasing degree of economic and political uncertainty. Within this environment, ensuring that transactions do not get derailed is imperative.

The main options are paying dividends, stock buy-backs, internal investments or acquisition. Inorganic options can be very attractive to accelerating growth strategies or making a real step-change.

Equally, on the sell-side there are compelling reasons for selling. Competitive factors are often a feature of the willingness to sell, such as the lack of scale, the need to refocus on core activities elsewhere, or even something as simple as the strong valuations being opportunistically grasped.

Despite a downturn in M&A activity in EMEA in 2019, insured volumes have held up well and there is significant opportunity for the insurance market to further build its capabilities to support both buyers and sellers to manage the risks of a transaction.

The evolution of insurance solutions in M&A transactions

W&I policies first emerged during the 1990s

M&A related insurance solutions were first written at Lloyd's during the 1980s to cover specific tax risks that were challenging clients at the time. As underwriters were further exposed to the M&A market, the Warranty & Indemnity (W&I) policy emerged during the mid to late 1990's. Aon also entered the marketplace in the 1990s and has grown its market position to become a global frontrunner in the space. By the millennium, a small number of corporate insurers and Lloyd's syndicates had created dedicated teams to write the fledgling business. Initially, these products were somewhat inflexible, took time to place, and policies were significantly more expensive than they are today. The market developed slowly but steadily through the early 2000's, with deal makers in Australia and the UK using the products most regularly.

In the early days of the market, underwriters tended to be experienced financial lines practitioners who developed an understanding and appetite for M&A risk and who would supplement their own knowledge with comprehensive advice from outside counsel. In the mid 2000's, brokers and insurers began to employ former corporate lawyers as underwriters which led to more efficient underwriting and faster turnarounds. It is now routine for brokers and insurers to incorporate experienced M&A, tax and legal professionals into underwriting and broking teams. This has not only helped the insurance industry cultivate a stronger relationship with the legal and professional service firms that facilitate M&A transactions but has also allowed the market to create more bespoke offerings for the insured as both brokers and insurers are familiar with the deal mechanics and timeframes. This has contributed to significant annual growth of c.45% in the number of policies placed, from approximately 300 in 2011 to 3,200[1] in 2018.

The entire market slowed during the financial crisis, but insured volumes did not decline materially because the products were providing real value and penetration was still relatively low.

As the global economy recovered and M&A rebounded, M&A insurance solutions began to gain traction, especially in the US but later across Western and Southern Europe where local markets began to develop to the extent that Aon's global book alone has trebled between 2014-2018. The London market and Lloyd's particularly has been central to the growth. A growing number of syndicates have backed a plethora of MGA's and consortiums in both Europe and the US and the market today comprises roughly equal numbers of insurers (including Lloyd's syndicates writing the business open market) and MGA's.

1 *Source: Aon estimate based on Aon and market practitioner insights*

The global market for insurance solutions in M&A today

Today the core products include W&I insurance (known as Reps and Warranties (R&W) in the US), tax insurance, litigation insurance and other contingent risks. Aon has also found new ways to deploy more traditional forms of insurance capital such as credit, surety bonds, parametric instruments and environmental insurance into M&A deals that provide our clients with solutions to issues thrown up in both the private and public deal space or as a means of delivering a positive impact on the financing terms of individual deals.

- **W&I insurance:** the largest product by premium volume. Protects the insured party against financial losses (including defence costs) resulting from unknown breaches by a seller/warrantor of the warranties and indemnities given in a sale and purchase agreement. In its early days the insurance was taken out by sellers, but today over 95% of policies are issued to buyers in the form of first party contracts. W&I and R&W policies essentially cover the same thing but underlying sale and purchase agreements in the US tend to be more favourable to buyers and thus coverage under a R&W policy tends to be broader. Insurers writing business both in the US and Europe need to be keenly aware of the differences if they are to operate successfully in both markets.

- **Tax insurance:** insures for financial losses associated with adverse rulings by tax authorities regarding the validity of tax positions discovered during due diligence, such as the anticipated tax associated with the transaction e.g. debt for equity swaps or loan note repayment.

- **Litigation and contingency insurance:** insures for losses arising from an adverse judgement in an existing litigation (or if only contemplated) which could otherwise frustrate a transaction. It covers the loss, whether damages or legal costs incurred (both defence and other side's costs). The cover for damages is of most interest and what sets it apart from legal expenses cover such as BTE (Before The Event) and ATE (After The Event) insurance, which covers the costs of a legal dispute.

- **Other specific insurance solutions** can assist in transaction process and help facilitate seamless deal closures. These solutions are typically bespoke to the insured's requirements and sold alongside a W&I policy. They might, for example, include environmental or cyber policies dovetailing with the W&I policy, although there remains much work to be done to create genuinely seamless products.

As the market continues to evolve and become more sophisticated, insurance products will increasingly become a core part of the deal process, enabling insurance capital to be arbitraged against more traditional and expensive money to solve deal related risk issues.

What value do these solutions provide?

The case for implementing W&I is compelling for both corporate and private equity firms. For corporates, the ability to free up capital on the balance sheet is often a primary driver.

> "Rather than having an escrow put in place, or a contingent liability on your balance sheet in relation to divestments you've carried out, you can turn to W&I insurance and basically transfer it for a fraction of the amount of capital you'd otherwise need to reserve on your balance sheet"
>
> Partner, European Law Firm

For private equity firms (and corporates to some extent), when market conditions favour sellers, it is common to exit investments or business units via a competitive auction process. Sellers typically hire an investment bank to structure and run the auction and ultimately secure the best price. Historically sellers needed to balance the price against the liability recourse required by bidders to decide which bid represented the greatest value. For example, a high price accompanied by a demand for significant warranty cap backed by an escrow may be inferior to a lower price with a lower or even zero recourse cap and no escrow.

Early adopters (on both the buy and sell side of the deal) realised that they were able to overcome this conundrum by using insurance. For example, taking out a W&I policy (and other adjacent policies to reduce the exposure of known risks) allowed the buyer to offer a competitive price while releasing the seller from retaining any meaningful liability. As awareness of the products was still growing, savvy buyers were able to materially differentiate their bids and win auctions whilst competing bidders became entangled in escrow negotiations.

Sellers are now fully aware of how insurance can be utilised to facilitate an auction and are increasingly stapling a close to final form insurance solution to their deal terms to ensure that all bidders adopt insurance as part of their offer. As auctions become more hotly contested by bidders, insurers and brokers have been challenged by the M&A community to meet tighter deadlines while dealing with multiple parties. Insurers with larger teams, more diverse capability and meaningful capacity are well positioned to capitalise on these opportunities

A simplified case study can clearly demonstrate the value of insurance products during the transaction process, by comparing a deal using a traditional escrow approach and one using insurance. A PE firm will typically target an IRR/RRR of over 20%, so any funds tied up in escrow are funds that can't be used for other investments:

Deal Assumptions	
Enterprise Value:	€100,000,000
PE target IRR/RRR for investments	20%

Without insurance:	
Escrow (as % of deal value)	10%
Escrow (€)	€10,000,000
Duration of escrow	12 months
Opportunity cost of escrow[2]	€2,000,000
Escrow fee (0.50%)	€50,000
Total cost of escrow	**€2,050,000**

With insurance:	
Insurance limit purchased: *(as a % of deal = escrow replacement)*	10%
Cost of insurance (rate on line)	1.5%
Total cost of escrow	**€150,000**

Value to a typical PE Investor	
Cost of escrow avoided	$2,050,000
Cost of insurance	- $150,000
'Value' created for PE Investor	**€1,900,000**
'Value' created as a % of deal value	**1.9%**

Aon has recently partnered with the Financial Times to produce the C-Suite Leadership Series. In this report we gather insights from leading dealmakers at corporate buyers, private equity and real estate funds, investment banks and law firms, to understand how M&A transaction practices are evolving. We explore how to develop deeper insights, hedge risk more effectively and extract more value from intangible assets. In short, we believe that insurance capital can be deployed into M&A transactions in increasingly diverse and creative ways providing insurers with opportunities beyond the W&I market.

2 "Opportunity cost of escrow" based on the return a PE investor (which typically targets an IRR/RRR of 20%+) would be seeking to achieve on funds that would otherwise not be tied up in escrow.

Market dynamics and the key players

Insurers

Increased competition. Lower premiums. Broader coverage

More insurers attracted to the market, leading to:

- Increased capacity and ability to underwrite "mega-deals".
- Softer rates (i.e. lower premiums).
- Broader coverage and value-adding propositions.
- Acquisitions of MGAs (e.g., Brit acquisition of Ambridge).
- More compelling claims offerings.
- European insurers writing US-style policies if insureds are willing to pay higher premiums for broader coverage.
- Pressure from Lloyd's of London and capital providers to create profitable growth.
- Ability to offer a more holistic M&A solution, including other product lines such as environmental, surety and credit risks.

Insureds

Reduced prices and increased awareness

- Developing more sophisticated understanding of product value proposition.
- Benefit from wider choice of providers, with increased capacity and wider coverage.
- In certain countries, insureds benefit from a growing availability of local language policies.
- Benefit from a more streamlined and less invasive underwriting approach, leading to the ability to purchase cover quickly.

Lawyers

Influencing insureds to purchase coverage

- Increasingly aware of available products and likely to use them or recommend them to their clients (initial scepticism about use of Transaction Solutions products is considered to be largely over).

Insurance Brokers

Seeking new ways to add value

- Building capability to deal with more enquiries (incl. local language capability).
- Increasing efficiency while continuing to add value incl. exploring facilities.
- Exploring cost-effective solutions to emerging segments, such as in the SME sector.
- Seeking to add more value to the transaction itself e.g. capital advisory and consultancy.

MGA's

Large presence. Close to saturated.

- MGAs constitute c.50% of all capacity, which is significantly higher than other lines.
- Increasingly crowded market, 10+ MGAs competing for business in London and Europe.
- Many MGAs are sophisticated and able to offer some of the most flexible coverage.
- Pressure from Lloyd's of London and capital providers to create profitable growth.
- Insurers are looking to MGA's as a way of entering the transactional solutions market.

2018 market facts

$2.3bn
2018 global W&I market

35%
Global W&I Annual Growth 2014-2018

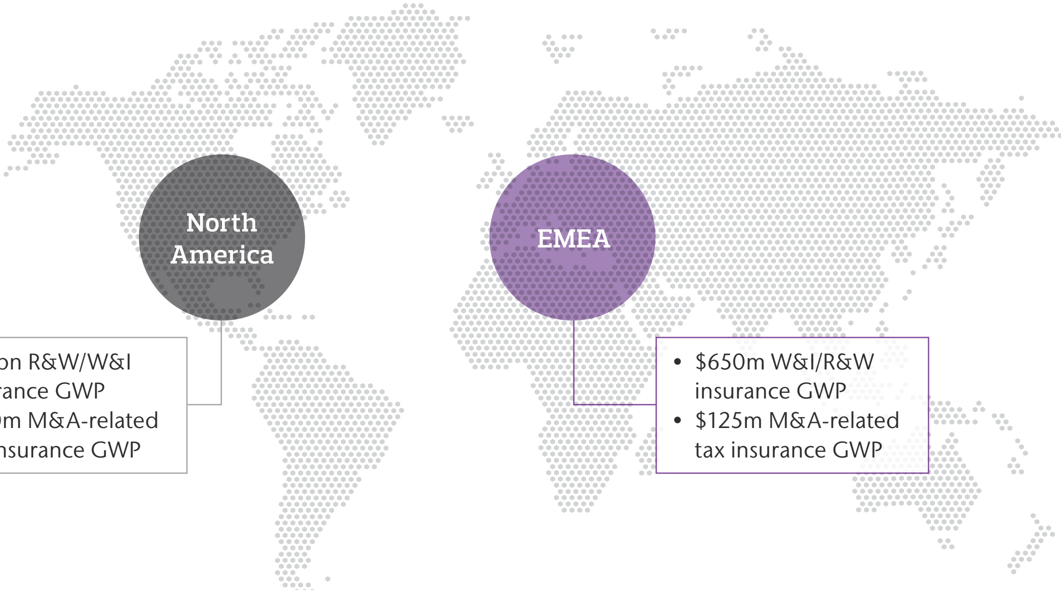
3200
Deals transacted globally using W&I in 2018

$275m
2018 global tax insurance market

2%–6%
Pricing of tax insurance as % of limit placed

$1.6bn
Aon's 2018 capacity for tax insurance (incl. ACT)

$750m
2018's largest limit tax policy placed by Aon



North America:
- $1.4bn R&W/W&I insurance GWP
- $150m M&A-related tax insurance GWP

EMEA:
- $650m W&I/R&W insurance GWP
- $125m M&A-related tax insurance GWP

Typical premium and retention rates by region:

	US	Europe	Asia Pac (incl. Australia)
Premium rates	2.8%–3.5%	0.6%–2%	0.8%–2%
Retention	1%	0%–1%	0.5%–1%

"Where once, a corporate tax director's priority was to minimise tax bills, in today's complex and politicised tax environment, managing tax related risks is key. Tax insurance has been used by Aon clients to manage billions of Euros of tax related risks – in a wide range of M&A and other situations. While the GWP for this product has seen very significant growth in recent years, we believe there is scope for dramatic further development, as the use of tax insurance becomes more accepted in corporate tax departments and in M&A deals worldwide"
Director, Tax Insurance at Aon

Emerging products and evolving risks

Increased penetration of small and medium sized deals

According to Pitchbook, only 6.7% of the total value of M&A deals in 2018 originated from deals under $100M, however this relatively small deal-size bracket accounted for about two-thirds of deal volume. The small and medium deal-size bracket represents most of the volume of deals yet is an under-penetrated space for insurance-based M&A solutions. At present, premiums are too low for most insurers to consider economical, yet this is arguably the biggest 'white space' in the market today. If enough of the volume could be insured, we believe that a portfolio underwriting model could be adopted.

This segment will require innovators to develop an enhanced underwriting model to better serve small and medium deals. There may be an opportunity for leaner entities, such as MGAs, to better serve this segment and indeed a couple of them have deliberately targeted this space. Insurance brokers may also begin to establish market facilities, as is the case with more mature lines of business.

This segment of the market is not without its challenges. There is some evidence that there is a higher percentage of claims for the smallest deal size policies (deals of $25m or below). This is due, in part, to less sophisticated internal controls and processes within the target company and a lower standard of due diligence conducted on the buyside. Insurers looking to penetrate the small deal space should therefore be vigilant in evaluating the insured or consider whether a different approach to rating is appropriate.

> "Bigger deals are actually better from a risk profile perspective. These clients and their legal counsel are generally more sophisticated. Larger deals are able to invest in quality rather than saving money. Looking at claims history, there is a higher percentage of claims in smaller deals"
> President, M&A Insurer

Streamlined underwriting

Technological advancements to the underwriting process are yet to fully impact established methods. Some insurers are in the early stages of utilising software to expedite underwriting, but a significant degree of automation is some way away.

Streamlined underwriting is going to be critical from the perspective of being able to efficiently underwrite smaller deals. A more commoditised offering will be essential to penetrate this part of the market. Successfully developing a more efficient, low touch underwriting process is the key to winning in the smaller and medium sized deal space.

> "A different underwriting model is required for small and medium deal sizes. Once you're below a certain level of deal size, the level of advisory services decreases. You also deal with founder sellers and founder targets. Family targets tend not to have gone through the robustness of corporate diligence"
> Director, London MGA

However, we shouldn't underestimate the opportunity to challenge the way the market currently works for bigger deals too. The often intense time pressure that larger deals are under, cannot be delayed by an inefficient underwriting process, so we need to challenge the market to work differently. An example could include 'gross lining' with one insurer fronting the risk, with pre-agreed capacity supporting in a reinsurance structure.

Growth of tax insurance, especially for large deals

Tax insurance policies and other products for 'known risks' currently constitute a relatively small segment of premiums written. The tax insurance market has great potential for growth in Europe, with some insurers having already begun to build dedicated local tax teams. While Aon Inpoint does not predict that tax insurance will become a larger market than W&I, we expect to see a growth environment where large carriers in Europe could expect c.20% of their M&A related GWP to be derived from tax insurance products by 2025. Tax insurance also has potential to penetrate outside of the immediate M&A timeline as the international tax environment becomes ever more challenging to navigate and insurance is increasingly demanded to protect against such complexity. Even companies not currently undergoing a transaction may deem it prudent to transfer the known, but uncertain tax liabilities of a previous transaction from the balance sheet to an insurance policy. It is worth noting that 2019 has seen a significant increase in both market capacity and individual underwriters with appetite for tax risk.

Growth in synthetic policies

W&I insurance has pushed the boundaries of how M&A transactions are structured albeit within a set of conventionally recognised parameters. Synthetic warranties are a new and potentially disruptive product that could eventually replace W&I polices as we currently understand them, although we think that is unlikely in the short to medium term. Synthetic warranties would represent a significant departure to the way deals are done, where a seller would no longer give warranties to the buyer, but the buyer would negotiate a set of warranty-like statements with the insurer. As yet, this innovation has only been tested a handful of times and only a few insurers are willing to offer this type of product. In synthetic structures the role of due diligence is even more critical to insurers because the sellers effectively absolve themselves from the process. Some insurers worry that the lack of any recourse to sellers, even in the event of fraud, creates significant and insurmountable moral hazard. Given the heightened importance of due diligence in a synthetic structure, insurers may decide to conduct due diligence themselves which would be a fundamental departure from the way the market currently operates and would have significant implications for the timing and underwriting process. One insurer has already adopted this approach for smaller real estate transactions. We suggest that synthetics be considered on a cautious basis with a priority being to ensure that the inherent due process which is traditionally required to support good quality M&A transactions is not undermined.

"A synthetic warranty product has a single set of due diligence – you can effectively create a transparent market of real estate assets operating in the UK"
Head of M&A, M&A Insurer

Transaction Solutions and public M&A

An interesting and emerging part of the current global marketplace is public M&A. Aside from 'Public Offering of Securities Insurance', insurance products have historically had little application to public M&A. There are typically very few, limited, or no warranties provided by the target company or its shareholders in public deals meaning that W&I insurance is simply not relevant.

Aon has recently challenged the market to come up with more innovative solutions to meet client demand for greater downside protection in the public markets, whether in an M&A context or otherwise. This has meant engaging with insurers both in and outside of the current M&A space and has resulted in a number of ground breaking placements. Examples include

- Structuring and placing a surety bond to back a cash confirmation obligation in a UK public takeover.
- Structuring and placing a synthetic W&I policy for a public to private transaction in Poland.
- Placing a tax policy for a public company to preserve the tax treatment arising from a redomicile of its IP assets.

These examples barely scratch the surface of what Aon perceives to be the unmet needs for solutions in the public M&A transaction arena. Those insurers who are creative and nimble enough to flex current products and develop new ones will be well positioned to benefit from the opportunities presented.

"W&I has been a real pathfinder in boosting people's awareness of how insurance solutions can be deployed in transactions"
Managing Director, Private Equity firm

Claims handling must keep up with market demands

Some insurers report that around 20% of W&I policies result in claims notification (NB notifications as required by the terms of the policies not settled claims), which is broadly supported by Aon's own data. AIG's recent 2019 report[3] "Taxing times for M&A insurance" highlights that claims notification frequency has increased to 26% for deals between USD500 million and USD1 billion, while claims severity has also grown, with material claims over USD10 million doubling year on year from 8% to 15%. Claims can be significant, for example:

- One of the largest claims paid to date was paid to the Japanese beverage conglomerate Asahi relating to their 2011 purchase of New Zealand based Independent Liquor's from Pacific Equity Partners and Unitas; USD 138 million was paid out by insurers AIG, Beazley and Allied World.
- In April 2019, private equity firm FSN Capital announced that it received a payment of EUR 50 million from a consortium of twelve insurers, led by Liberty, for losses incurred in connection with breaches of accounting warranties when it acquired Gram Equipment from Procuritas.

> "It is rewarding to see the W&I insurance product actually works when needed"
>
> Thomas Broe-Andersen, Partner, FSN Capital; press release, fsncapital.com 1 April 2019

The importance of effective claims handling

Insurers must not underestimate the importance of claims handling and tailor their response to purchasers of the product. Growing price-sensitivities on the part of the insured needs to be balanced with clear explanations of the cover that will be afforded in the event of a claim. Lawyers can be influential in a client's decision to purchase M&A insurance as a deal facilitator, but the product also needs to serve its purpose to pay out when there is a covered claim.

Prompt claims payment is a primary concern of the insured in this market, more so than some others. As the market matures, efficient claims handling will enhance the appeal of insurance products in the M&A space. Conversely, there is a risk that poor claims handling could undermine the product and erode the trust, which has been cultivated among M&A advisers and lawyers. Insurers' claims track record and their ability to respond quickly to and pay out on claims is key. If insureds do not see W&I products as a reliable tool, they could easily revert back to alternative solutions, such as use of escrow.

The loss environment

Considering that only a small number of claims have been litigated in the U.K. or European courts and that the terms of private settlements are usually confidential, it can be difficult to assess the full scale of W&I claims. While it appears that both W&I and Tax insurance claims have been manageable for insurers in the market to-date, claims handling is still being tested.

Quantifying loss can be complex. It is likely that forensic expert accountants will need to be instructed. Whereas in English law, loss under a W&I policy will ordinarily mean that the buyer is entitled to claim the difference between the 'true value' of the company and the 'as warranted' value (unless some other express agreement has been reached), the position is different in other European jurisdictions.

The split between types of warranty breaches will vary depending on the book of business and geographical locations though common areas of dispute include, but are not limited to, financial statements, tax, compliance with laws and material contracts. Due to the bespoke nature of W&I policies and the varying positions under different legal jurisdictions, the policy and underlying deal documents need to be carefully considered in the event of a claim.

3 *"Taxing times for M&A Insurance", AIG Claims Intelligence Series, 12 June 2019, AIG.com*

Moral hazard increases as W&I evolves

Fundamentally, W&I insurance is designed to cover the unforeseen risks that remain following a robust due diligence and disclosure process. The more robust the due diligence process, the more risks become known rather than unknown and therefore fall out of scope of what a W&I policy is intended to cover. Potentially, there could be some moral hazard associated with the temptation to undertake less robust due diligence, expecting any shortfalls to be covered by insurance. However, this is partly mitigated by the fact that not only do insurers exclude known matters from cover, they also exclude areas that have not been the subject of diligence. Underwriters will always need to judge the extent to which the existence of insurance affects the transaction process (if at all) and adjust tailor their underwriting accordingly.

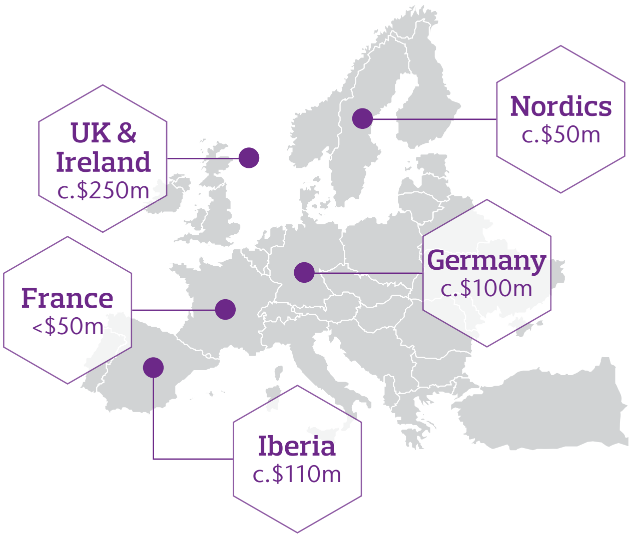
"Lawyers are interpreting facts and the law – some may take a more generous or riskier position than they would have otherwise because there is insurance"
Head of M&A, M&A Insurer

"One of the biggest challenges facing the Transaction Solutions market is that insurers must deliver more and more while due diligence does less and less. Audit firms can churn out boilerplate due diligence. We have a system where W&I policies cover unknown risks. The weaker the due diligence is, the more unknown risks there are. This is potentially very dangerous for W&I"
Director, London MGA

Spotlight on Europe: the landscape and the opportunities

The European marketplace for insurance products has grown significantly. Across Europe there have been different levels of uptake of insurance products to support M&A transactions. The highest penetration has been in the UK & Ireland, Nordics and Germany. France has had the lowest relative penetration of the major economies, whilst Iberia is relatively large but still has plenty of headroom in terms of penetration.

W&I GWP by key European country



Sources: Aon premium data, Thomson Reuters, Pitchbook, Allen & Overy

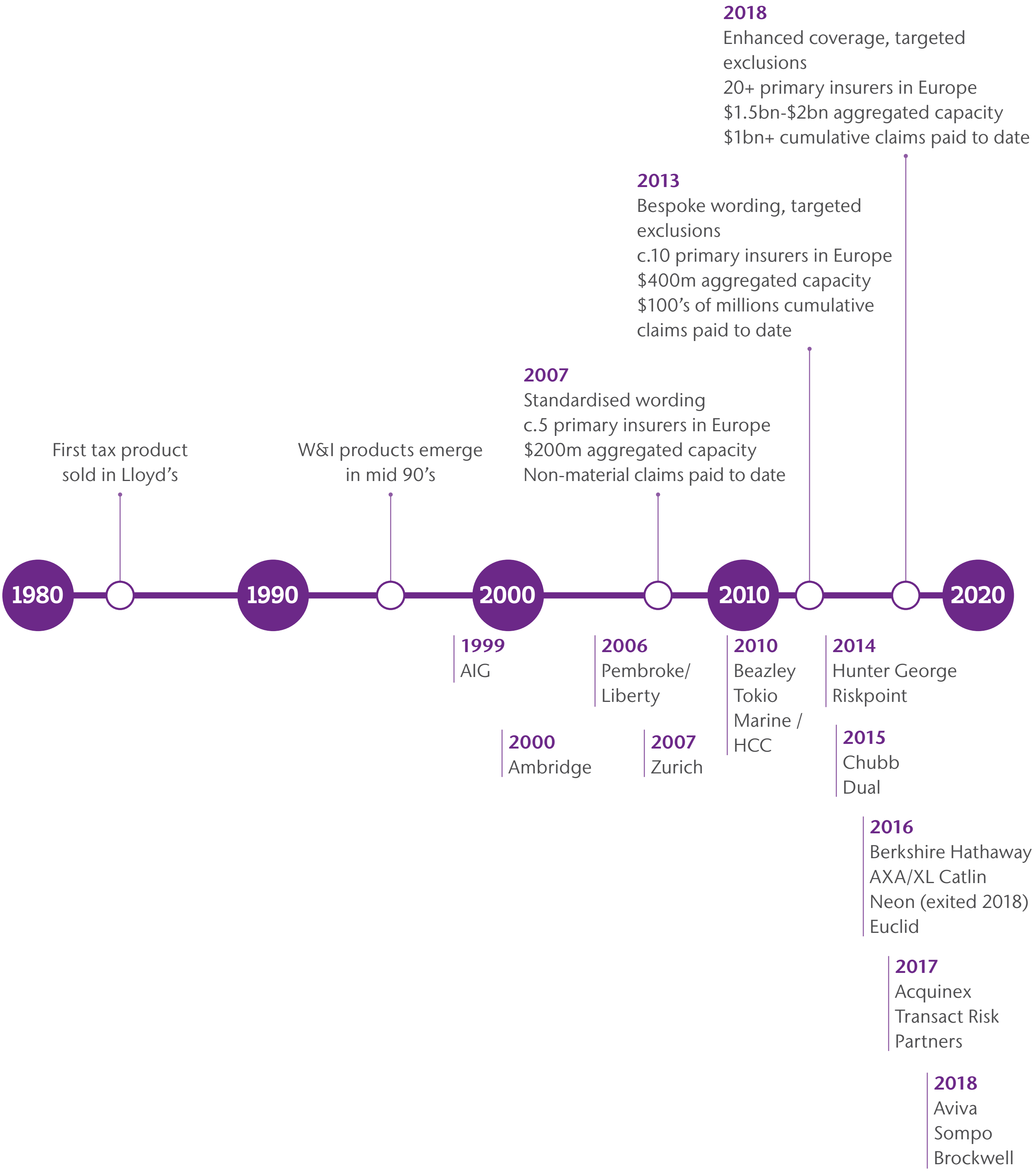
There are three main drivers of the growth in the insurance solutions for transactions in Europe:

1. **Strong European M&A market.** According to Thomson Reuters, Europe was responsible for 31% of overall global M&A transactions by the first half of 2018. The continuing availability of cheap debt (as people try to get better returns on their capital as risk-free rates are so low/negative) has provoked companies to embark on M&A before borrowing costs rise. In part, this has helped with the return of the "mega-deal", although activity is down significantly in 2019.

2. **Increased awareness of insurance solutions for transactions** amongst lawyers, bankers and investors. Traditionally the PE community have been the most prolific buyers of products, but now there is significant growth in the use by corporates as they compete against PE buyers in auction process's. Some corporates have also adopted a PE approach when selling down non-core operations, insisting on limited warranty packages and mandating that bidders use insurance. There has also been a growth in seller-initiated insurance purchases to allow the seller to more effectively manage deal risk and facilitate a more structured deal.

3. **More attractive and easier to purchase propositions.** More insurers are now underwriting insurance products for M&A transactions than ever before, which has led to a fiercely competitive market in some sectors and deal-value bands. As a result, insurers are developing more compelling, sophisticated value propositions for their insureds, with fewer exclusions and broader terms to insureds while simultaneously cutting rates and retentions (deductibles). Most insureds will value deal execution and policy cover over price alone. Insurer capabilities are also being increasingly deployed more locally as well, with propositions tailored to local legal and regulatory systems, and importantly, policies written in local languages in certain territories (for example, France), albeit less so in others (for example, the Netherlands).

Developments in the European marketplace



Only EMEA carriers with $50m+ capacity as of Q1 2018 are named.

Additional carriers are active in the market who provide less than $50m worth of capacity.

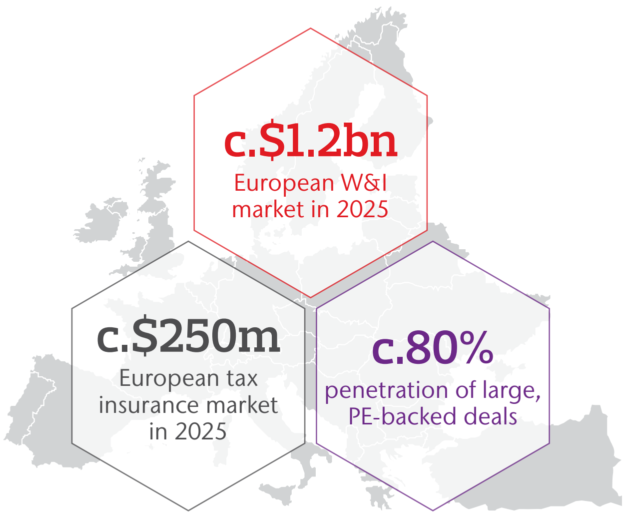
Spotlight on Europe: the future forecasted

As we look forward to the state of the M&A insurance marketplace in 2025, there will be some significant opportunities but also challenges:

Growth

Aon Inpoint expects that the global market for M&A related insurance products will continue to grow over the next five years at a similar pace as we have seen over the past several years, driven by increased awareness of the product and growing confidence in product performance by M&A practitioners. Despite M&A activity being significantly reduced in Europe in 2019, the political and economic uncertainty in European markets is expected to contribute to healthy M&A activity, especially in the private equity space and with larger deals. Ultimately, Aon Inpoint believes that the market will reach a saturation point in which up to 80% of large PE-backed deals will use a W&I policy. By 2025 the European W&I market could reach as much as USD 1.2 billion, based on increase in take up rate, increase in capacity purchased and a decrease in premium rates.

The European M&A market size prediction in 2025



Localisation of the market hindered by lack of qualified talent

The marketplace for insurance related to M&A transactions in Europe is becoming increasingly localised as insurers put more ‘boots on the ground’ in mainland European countries. Locally-based insurers have more detailed knowledge of country-specific legal systems; however, the relative scarcity of qualified talent limits the growth of local teams. Policies for M&A transactions are by nature highlybespoke products that require substantial levels of expertise, so it is challenging for insurers to quickly build teams capable of writing these policies effectively. There is certainly more demand and opportunity for increased local capacity, but insurers in Europe will have to compete for the qualified talent that these roles require.

Aon Inpoint predicts that Germany and Spain will be the fastest growing markets between now and 2025, driven by demand for local insurer coverage and increasing uptake by insureds. There will also be increased demand for local-language policies in some European markets, most notably in France. Spanish-language insurers can take advantage of the growing market in Spain, as well as the demands for products from Latin America, although the Latin American market is still early in its development.

An evolution of coverage

Over the past few years in Europe, the demand for US-style W&I policies has increased. This has been driven by US buyers who are investing in Europe trying to drive US terms and structures into European sale agreements. Aon Inpoint expects this trend to continue up to 2025. Over a longer horizon, the differences between US-style and European-style policies is expected to diminish as W&I policies will begin to converge with clearer and shorter policy wording.

At times, US clients demand R&W style coverage even where that is not reflected in the underlying transaction documents. Aon has deep expertise in placing these so called “hybrid” structures and works with a panel of insurers with similar expertise to service its US clients investing in Europe. Premium rates in the US market are around 2.5 to 3 times the level in Europe so hybrid policies create rate opportunities for carriers in Europe, albeit in exchange for greater exposure.

Competitive pressures in the market are leading insurers to offer lower retentions, whilst insureds are also looking for wider coverage in policies. In this environment, there is great opportunity for underwriters to offer broader coverage with fewer exclusions, as insureds are willing to pay for a product that offers more comprehensive cover. Insurance brokers need to make sure that insureds understand the extent and limitations of coverage in a W&I policy and what can and can’t be done to improve it.

> "Pricing has reached an inflection point where consumers are wanting to pay more to get better coverage or build in additional enhancements"
> Managing Director, UK MGA

Aon Inpoint also expects some of the more sophisticated insurers to look at opportunities from offering combined policies to cover the unique risk profile associated with a specific deal. These more sophisticated insurers are already starting to offer a suite of products tailored to the insured, including W&I cover combined with offerings such as recall risk for manufacturers, IP risk for technology companies and environmental risk for industrials.

Conclusion:

Insurers with effective strategies can be successful in capitalizing on the growing and profitable marketplace, especially within Europe. As insurers begin to offer broader coverage, serve local European markets and penetrate the small and medium deal size bracket, we will see increased awareness and uptake of the products. Tax insurance will be a major growth area, as the value proposition of tax insurance products extends past the M&A deal itself. The opportunities for insurers are vast and early innovators will be rewarded within the exciting and dynamic marketplace.

The M&A community has shown that it values the enabling role that insurance can play and has increasingly challenged the industry to develop ever more innovative solutions to meet the challenges it faces. Insurers that can respond to this need and find creative ways to deploy capital will be well placed to benefit from the opportunities presented.

How Aon can help risk carriers thrive in M&A insurance

Growth, profitability and innovation are the key challenges facing many insurers and reinsurers. The M&A marketplace presents an interesting area for insurers and reinsurers to offer compelling insurance offerings. It is entirely non-correlating with most other exposures and offers especially good diversification from property catastrophe exposures. Aon Inpoint has already advised several insurers and reinsurers on how they could enter the M&A space and build a strong proposition for clients[4], including:

- Evaluate potential challenges and opportunities in the evolving M&A landscape.
- Help develop business plans for potential investments.
- Help develop innovative products for insurers and reinsurers.
- Assist insurers in creating and executing go-to-market strategies.

Aon Inpoint has also advised buyers and potential buyers of insurance assets (for example PE firms and insurers), with commercial due diligence and 'red flag' analysis on proposed acquisitions. Red flag analysis can identify any potential issues or concerns with the market in which the target operates or the concerns with the target itself. This exposure to the deal environment, gives a robust understanding of the potential opportunities and challenges for insurers entering the space.

Furthermore, being a complex and still evolving marketplace benefits hugely from a multi-disciplinary team with a background in insurance and reinsurance, but also the underlying activity of M&A. Aon Inpoint works seamlessly with Aon's M&A subject matter experts in the Transaction Solutions practice group, which brings together expertise from both insurance related areas and those with vast experience on the buy-side and sell-side of M&A activity. This includes underwriting and broking professionals, as well as those from finance, private equity, legal, investment banking and operations backgrounds.

Aon Inpoint is dedicated to making insurers and/or reinsurers more competitive through providing data, analytics, engagement and consulting. Aon Inpoint supports the entire insurance value chain, from our clients to producers, account executives, retail and wholesale brokers, insurers, cedents, reinsurance brokers and reinsurers, to provide valuable solutions and greater choice to our clients. Working collaboratively with colleagues from across Aon, we bring together unique insights and foresights that might otherwise get missed. We always look to structure the challenge of such a complex topic to ensure that near-term benefits are realised by insurer and reinsurer clients, whilst adapting and preparing for the longer term.

If you are interested in learning more, there is a wealth of further insights available from Aon's subject matter experts, especially in the Transaction Solutions team. If you are interested in talking to Aon Inpoint about how we could potentially help your organisation, please get in touch with one of the Aon Inpoint team below, or your usual Aon relationship contact.

4 Aon Inpoint does not provide investment advice.

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About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

Aon Inpoint services are provided by Aon Global Operations plc (registration number 08114746) whose registered office is at the Aon Centre, The Leadenhall Building, 122 Leadenhall Street, London EC3V 4AN, acting through the Aon Global Operations plc, Singapore Branch (registration number T12FC0122F) whose registered office is at 2 Shenton Way, #26-01 SGX Centre 1, Singapore 068804 ("Aon").

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