Lockton Transactional Risks
Market Update 2022/2023

Exploring New Horizons

global.lockton.com

Recent Deals We Have Worked On

Asset - Unity5
Buyers – Synova Capital
Sellers – Founders
Sector – Software
Jurisdiction – England

Asset – Student Housing Portfolio
Buyers – PGGM
Sellers – Greystar Capital
Sector – Living
Jurisdiction – Spain

Asset – LiveScore Group
Buyers – Ringier AG
Sellers – Undisclosed
Sector – Gambling
Jurisdiction – Global

Asset – Portman Square House
Buyers – BentallGreenOak
Sellers – AXA IM
Sector – Office
Jurisdiction – England

Asset – George Stubbs Insurance Services
Buyers – JMG Group
Sellers – Undisclosed
Sector – Financial Services
Jurisdiction – Scotland

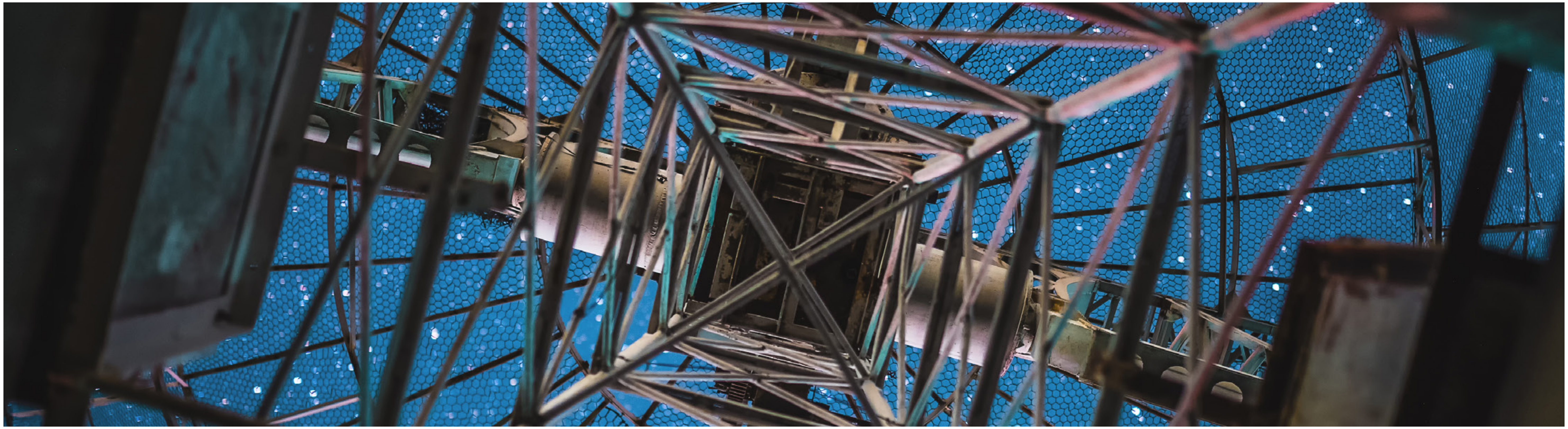
Asset - Enamel Dental
Buyers – Real Good Dental
Sellers – Undisclosed
Sector – Healthcare
Jurisdiction – England

Asset – TriStar Portfolio
Buyers – Prologis
Sellers – KKR/Mirastar
Sector – Logistics
Jurisdiction – the Netherlands

Asset – North Galaxy Tower
Buyers – KB Securities
Sellers – ATP Real Estate
Sector – Office
Jurisdiction – Belgium

Asset – KTC Edibles
Buyers – Endless LLP
Sellers – Undisclosed
Sector – Consumer Goods
Jurisdiction – UK

Asset – Grant Westfield Ltd
Buyers – Norcros PLC
Sellers – Undisclosed
Sector – Building Materials
Jurisdiction - Scotland



Introduction

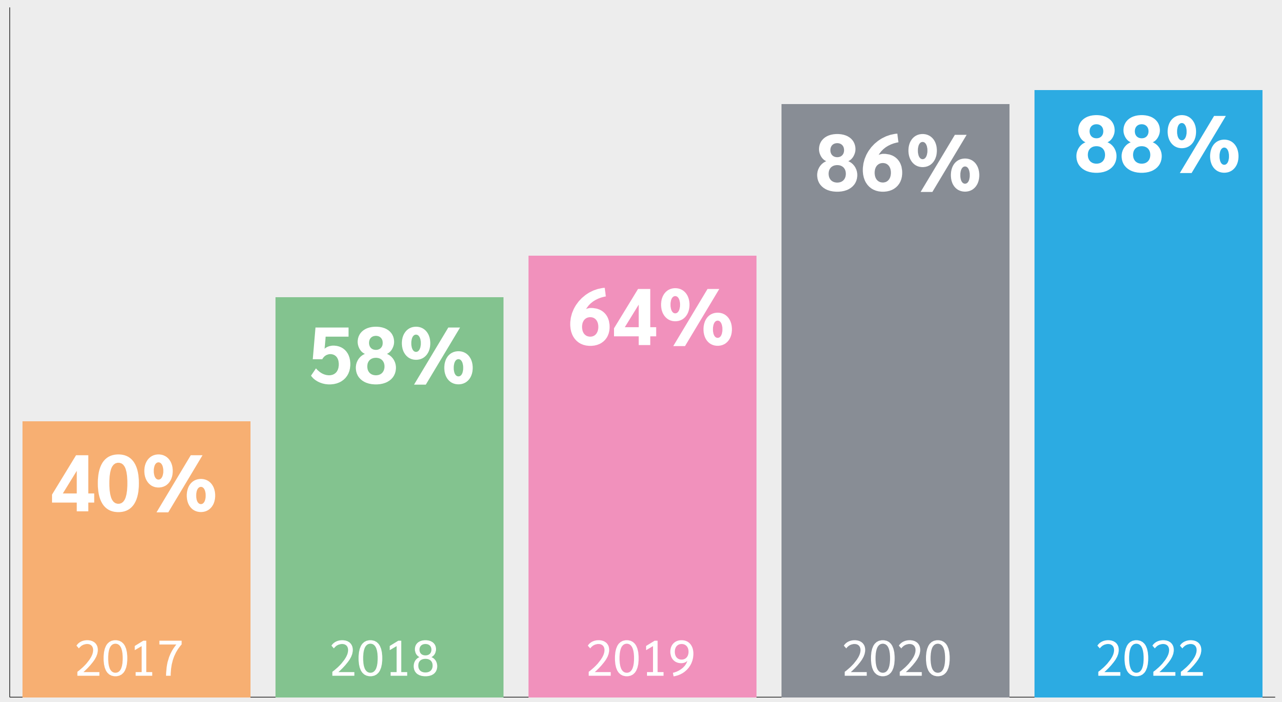
With the dust clearing on the pandemic-imposed lockdowns, dealmakers continued with a frenzy of transactions over the latter half of 2021 and into 2022. PwC Global noted a 24% increase in deal activity from 2020 and the Lockton Transactional Risks team placed over 350 policies across Europe; our busiest year on record. The flurry of dealmaking led to both positives and negatives in the transactional risk market. New products and innovative usage of existing products were stress tested in the white heat of dealmaking but capacity restraints from the insurance market, both financially and in manpower, led to difficult coverage and pricing for buyers in Q4 of 2021.

Whilst dealmaking continues, the mounting headwinds of inflation, supply chain and employment issues from lockdowns, the war in Ukraine, spiralling interest rates, commodity and energy issues and potential political instability continue to raise alarm bells for dealmakers.

Dealmaking was fairly concentrated on a few asset classes particularly living and logistics real estate, business services and TMT, the Lockton Transactional Risk team worked closely with investors across all asset classes placing insurance on transactions as diverse as the Scalpel office building in central London, an anaerobic digestion plant in Norfolk, the QO hotel in Amsterdam, a biomedical data analytics company in Denmark and a wind and solar energy farm in China.

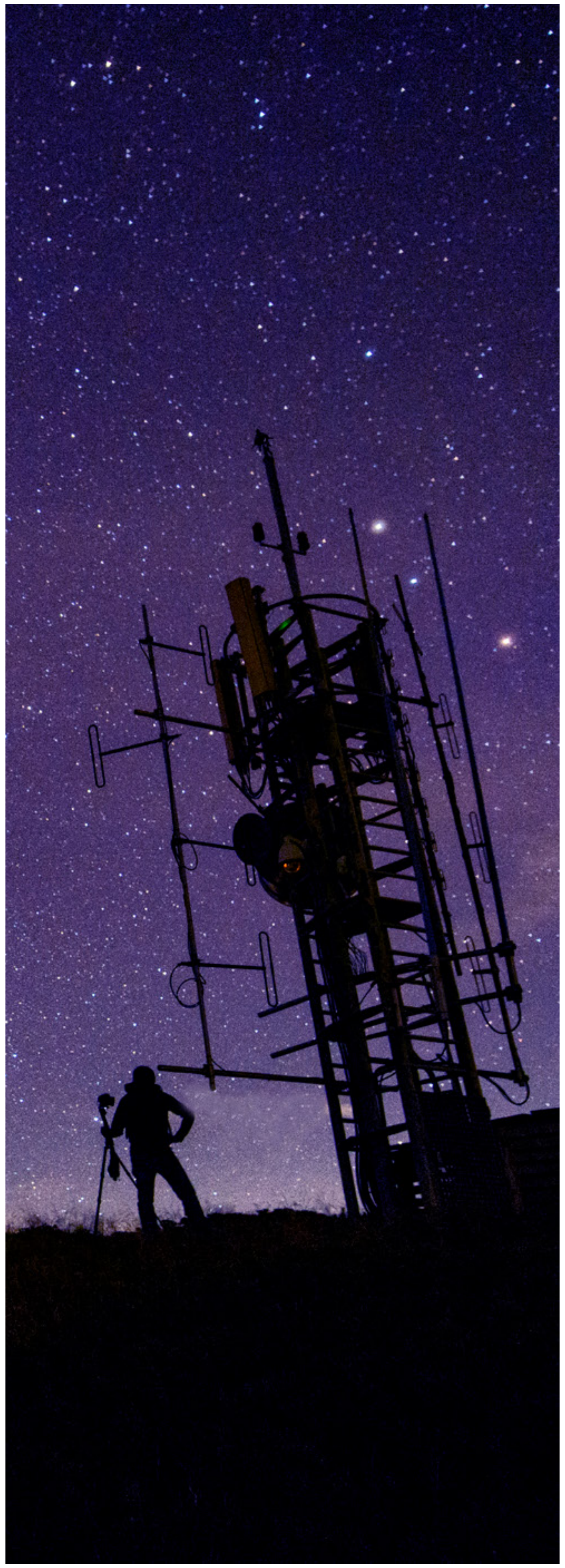
As we release this report in Q4 of 2022, however, we look ahead with optimism at a transactional risk market brimming with innovation, new entrants, technological and product development, and boundless enthusiasm to help dealmakers gain comfort, close difficult deals; and unlock value, whatever the market conditions.

Usage of W&I on deals <£100m



SOURCE Travers Smith Market Trends in Private Equity 2022

Team



The Lockton Transactional Risks team has further expanded in Europe adding specialist expertise across the board. We now have a team of 35 transactional risk professionals, adding sector expertise, as well as specialists in contingency and tax risks. In Q4 of 2021 the team was named M&A Broker of the Year at the Unquote British Private Equity Awards.

Our recent team additions include:

Manchester

Emily Chamberlain joined Lockton as a Vice President having qualified as a solicitor in 2012. Emily formerly worked in private practice at international law firms, spending over five years in the corporate team at Pinsent Masons as a general M&A lawyer before moving to Latham & Watkins where she focussed on transactional due diligence.

Faz Zaheer joined Lockton as a Assistant Vice President, specialising in insurance for tax specific items arising on corporate transactions. Prior to joining Lockton, Faz worked within tax for PwC, BDO and Croneri, where he specialised in advising privately owned businesses and individuals on both corporate and personal tax matters.

Harry Chrimes joined Lockton as a Junior Associate in Manchester. He joined us after completing studies at both the University of Glasgow and the University of Sheffield. Currently, he advises on W&I with a focus on the North of England and Scotland.

Tom Mullock joined Lockton as a Junior Associate in Manchester. Prior to joining Lockton, Tom worked in the PI department at Thompsons Solicitors. Tom graduated from Nottingham Law School in 2019 with a Bachelor of Laws. Currently, he advises on W&I with a focus on the North of England and Scotland.

Jack Burnett joined Lockton's Transactional Risk team as a Assistant Vice President in 2022, having previously spent a number of years working within the accountancy practice and tax sector. Jack covers the North of England deal space and works with Private Equity houses, Law firms, Corporates and Corporate Finance houses assisting on W&I Insurance, Tax Liability Insurance and Insurance Due-Diligence.

London

Ross Lima joined Lockton as a Senior Vice President having spent nine years at Shell where he acted as Senior Legal Counsel and led strategic M&A deals. Ross has extensive Energy experience, working across a breadth of specialisms including trading, projects, infrastructure, shipping and technology. Prior to Shell, Ross was an associate in the corporate team at Fieldfisher.

Alexander Rayner joined Lockton as a Vice President having worked in the contingent legal risk team of another international broker. Alexander started his career in private practice, working for five years at the London office of Kirkland & Ellis, where he trained and qualified into the arbitration and litigation team. Today, he advises clients on contingent and legal risk insurance solutions.

Somers Brewin joined Lockton as a Vice President from Herbert Smith Freehills where he worked as a corporate lawyer specialising in the real estate sector and advised clients on a range of corporate real estate transactions (including acquisitions and disposals, joint ventures and structured investments). During his time at HSF Somers was seconded to the Blackstone real estate team.

David Elphinstone joined Lockton as a Senior Vice President from Dorsey & Whitney where he acted as Special Counsel advising on cross-border and domestic M&A with a special focus on the insurance, technology and media sectors.

Jarrod Morgan-Evens joined Lockton as a Vice President from Lloyd's Register, a professional services firm in the maritime sector where he was Legal Counsel and acted on various deals within the energy, cyber security and certification services sectors.

Rachel Williamson joined us as Vice President from another international broker. Rachel has worked in the transactional risk space for over a decade. She brings a wealth of market experience having worked on hundreds of deals across multiple jurisdictions and sectors.

Oslo

Kristian Salte joined Lockton as a Vice President in the Transactional Risks department. He formerly worked as an investment banker, focusing on sell-side M&A, specifically within business services, and industrial companies.

Kjetil Berge joined Lockton as a Senior Vice President in the Transactional Risk department. He has previously worked as a lawyer at EY and Norwegian law firm Haavind, focusing on M&A, corporate law and corporate tax law.

In Q4 of 2021 the Lockton Transactional Risk team was named M&A Broker of the Year at the Unquote British Private Equity Awards.

35

transactional risk professionals

Key Themes in the Wider Insurance Market

Kevin Stout
Partner, Due Diligence

The last six months has brought unprecedented change in the insurance market. The escalation of the Russia-Ukraine conflict coupled with a post-covid lockdown demand surge has created a threat to the status quo of global growth and low inflation. Considering the sheer magnitude of across-the-board premium rate increases in, and around, 2021, the market for insurance is softening, except for cyber insurance and potentially motor (due to claims cost inflation). Since 2017, claims have increased 13% year-on-year, with most of the increases arising from external factors (malware, ransomware, and social engineering). This persistent increase in cyber claims has attracted scrutiny from insurers. In response, average premium per million dollars of limit has more than doubled year-on-year, with some companies experiencing increases in excess of 500%. Although the current outlook may seem bleak, there are many factors in play to soften the cyber insurance market, such as new insurers stepping into the market as well as higher security standards being more commonplace, for companies with revenues upwards of £1bn, and less expensive to implement.

With interest rates continuing to rise in response to inflation, we expect to see premium rate hardening start to fade. Restrictive changes to policies passed by insurers, be it in wordings, conditions, or exclusions, have already been accepted and passed on to the insurance market, particularly property and casualty. These macro and intermarket conditions all signal peak hardening conditions.

With these rapidly changing conditions, it is important to be an informed buyer and Lockton's Due Diligence team support our clients throughout the lifecycle of a transaction including:

- Ensuring the Insurance Programme of the target is fit for purpose
- Where there are uninsured exposures, suggesting solutions and risk transfer related alternatives
- Identification of the current and post close insurance expense.

Due Diligence Process

STEP 1
Engage stakeholders: understand expectations, objectives and timescales

STEP 2
Access data room

STEP 3
Collate data and review

STEP 4
RAG status and gap analysis

STEP 5
Produce recommendation report and actions

STEP 6
Present to stakeholders and close due diligence

Transactional Risk Insurance Market and Appetite

The underwriting insurance market continued to expand with new market entrants Mosaic and Fusion gaining traction quickly within the busy marketplace. There are now a total of 35 insurers offering transactional risk insurance products. We continue to see innovation and product development from insurers responding to client demands to risk transfer.

As noted in the introduction, the marketplace in Q4 2021 suffered capacity restraints both from a financial and headcount aspect. Some insurers hit their maximum annual premium budgets earlier than expected leaving fewer insurers handling an ever-greater enquiry flow. This resulted in:

1) Premium increases in certain sectors

2) A far more selective market for quoting deals and a more conservative approach to coverage

Whilst some brokers suffered greatly with this hardening market the Lockton TR team has always prided itself on its relationship with the market and working collaboratively with insurers to achieve the best results for clients – this led to insurers actively seeking to place deals for our clients over other brokers and hence our clients not being affected too badly by the changing market conditions.

As the market further widens with more MGAs and company markets entering the space, repeat buyers of W&I are starting to build up partnerships with insurers. As Laura Marcelli from DLA Piper notes "We are seeing repeat users of W&I specifically asking brokers to approach insurers with whom they have had a good previous experience, whether that be process-driven or due to the breadth of coverage offered. Often a particular issue has come up on a previous transaction and the insured liked the way an underwriter approached it. There is now also greater granularity in the requests that prospective insureds have: they are more aware of the likely obstacles to insurability at the outset of a transaction and are more proactively seeking flexibility within the product or recourse to contingent policies to plug the gap. Insureds do still pay close attention to the rate on line, but that is increasingly coupled with a keen eye on the coverage offered. It is now often the case that the chosen underwriter may well not be the least expensive but is offering better terms and competitive pricing."

Insurers continue to expand their product offering and their geographical reach. We see markets hiring specialist IP, environmental, title and contingent experts and opening additional offices, particularly across Benelux, DACH and CEE.

Exclusions

Insurers have now reached a near market standard when it comes to exclusions and we have seen the breadth of exclusions decrease substantially from the early days of the product.

Rebecca Bothamley, Partner at Mayer Brown, notes that when it comes to an exclusion it is key to understand "what the exclusion relates to and why the underwriter has required it (which will also influence the scope and breadth of the drafting). For example, an exclusion due to lack of diligence is usually fair, provided that it is relevant to the business and could result in material liabilities and is often drafted quite widely; whereas an issue specific exclusion should be drafted much more narrowly. Often we find that exclusions are included in the first draft policy as a way of getting more information from the buyer or setting expectations on what will be required for an exclusion to be removed."

Although insurers generally now take a sensible view, Bothamley does comment that sometimes brokers have to push back on "some 'industry standard' exclusions that are included in policies which are often not particularly material or relevant to the target group – for example COVID19, holiday pay and IR35/misclassification of employee issues."

The default position from leading markets is not to impose outright exclusions for topical areas (e.g., Cyber, GDPR), but to look at these from the "ground up" and be led by the scope of related Due Diligence and any findings arising from that.

Enhancements

Knowledge scrape

Insurers will often offer awareness scrapes for a 10–15% additional premium – either in relation to a general awareness qualifier that applies to all warranties (although these are becoming less common with the increase in £1 liability caps) or specific awareness qualifiers that apply to individual warranties. It is worth noting that insurers may still insist on some warranties remaining qualified by awareness.

Dataroom and diligence report scrapes

An artificial scrape of the general disclosure of either the dataroom or diligence reports (but not both) can typically be added to policies for an additional premium of 10%. Whilst insureds will still need to review the contents of the dataroom or the diligence reports (and confirm that they have done so in the no-claims declaration), the scrape shifts the burden of proof to the insurer in the event of a warranty breach.

Indemnity measure of damages

Whilst US insureds have often opted to synthetically apply an indemnity measure of damages under the policy (and thus align coverage more closely with the standard position in the US), we have increasingly seen non-US buyers also make use of this enhancement. The additional premium is between typically between 10–15%.

Affirmative cover for tax risks

Where low risk tax items are discovered in due diligence which would otherwise be excluded from cover, insurers may be willing to insure these on an affirmative basis under the W&I policy (as opposed to under a standalone tax policy). The additional premium will depend upon the risk.

Stapling Insurance into a Transaction

With auction processes increasingly common, sellers are often using transactional risk products, particularly W&I, to drive competitive tension and provide certainty to a sales process. Tom Leman, head of retail and consumer at Pinsent Masons notes "In a world of highly competitive auction processes the emphasis is on speed and certainty of execution. In a game of high stakes poker, once the price is agreed, the seller doesn't want anything to get in the way of closing out the transaction. W&I is a vital part of delivering on that strategy."

Sellers can implement W&I into the sale process either as a "hard" or "soft" staple. This strategy has historically been seen as a way for a broker to embed themselves into the deal and mitigate against the chance of being "flipped" out but there are some tangible benefits to stapling for a seller. John Farrugia, managing partner at finnCapp Cavendish, says that "when we are advising sellers on exiting a business, the ability to staple W&I into the deal has some very tangible benefits, it upfronts the discussions around the warranties and risk protection and gives them control of the process and the timing which can be paramount when running a competitive auction with multiple bidders." Deciding between a hard staple or a soft staple will depend on the deal dynamics, and both have their positives and negatives.

Soft Staple:

This is the more common approach, typically this will entail a submission to the market containing the auction SPA, an Information Memorandum and the latest set of audited accounts. Insurers will review these documents and feed their terms back to the broker who will then collate these into their broker report to be uploaded into the VDR for the benefit of the buyers. This may be in conjunction with a process letter outlining the terms of the brokers engagement and the work undertaken to date by the broker. Bidders or a buyer is then invited to reach out to the broker with a view to taking the W&I workstream forward and commencing the underwriting diligence with a view to putting a policy in place.

Leman writes that "if bidders are presented with an NBI report from a well-known and respected W&I broker then I see little value in the bidder bringing in its own insurance broker. That said, I have seen it where there are international buyers who are less experienced with W&I and want someone with whom they have a long-trusted relationship to provide advice on the benefits and downsides of relying on a policy."

Hard Staple:

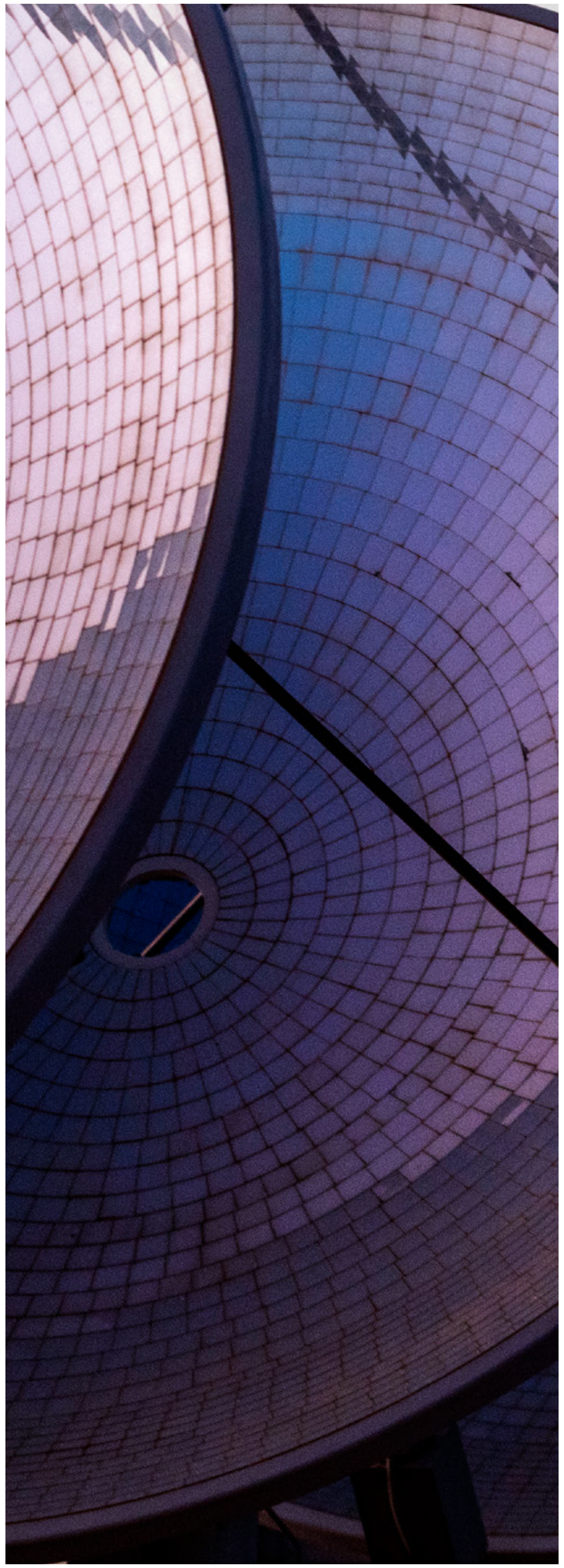
Becoming increasingly commonplace especially where sellers are trying to drive some competitive tension in auction run processes. For Leman "a hard staple neatly captures the risk/reward profile of the warranty protection earlier in the process and enables the bidder to make a judgement on whether the protection offered affects the price. A stapled policy completes the circle of protection – upfront due diligence and after the event recourse to warranties."

The benefit for the sell side is that more control is retained over the deal timeline, we have seen situations where the W&I workstream has been handed over to bidders without being hard stapled by the seller and this has led to a significant delay to targeted completion dates as the W&I workstream will be used as an excuse by the bidder as to why there is a delay in the process. By hard stapling the W&I workstream to the deal and handing that workstream over to bidders at the appropriate time, competitive tension remains between bidders and the W&I workstream has been sufficiently advanced on the sell-side so that the buy-side workstream can be materially compressed from what a normal W&I process would take.

There is a cost to hard stapling which for some sellers may be unpalatable – Leman comments that "the stapled policy helps obtain the best price for the asset. However, there is a potential cost. The stapled policy shifts the work forward to a time when there is less deal certainty. It increases adviser costs at a time when the bids are unknown. The sellers' lawyers will spend time negotiating the warranties, disclosure letter and policy and the other advisers and management will have to focus on providing underlying corporate information. On top of that the underwriter will charge a fee which remains payable even in the event the deal does not progress."

Control of the process is one of the major upsides of the hard staple, however we have also seen that much more control over cost and gaps in cover, where the buyer is alleging there are gaps in cover this is leading to commercial discussions around purchase price adjustments and potential holdbacks for indemnities – none of these are in the seller's interest and can potentially be avoided by a well-run hard staple process.

Looking to the future, it will be interesting to see the percentage of deals where W&I is stapled into the M&A process. Leman observes that market dynamics may change to make hard stapling less popular "as the macro-economic situation deteriorates, it's harder to predict valuations. If valuations are harder to predict then there is less deal certainty. In this context I suspect we will see fewer sellers prepared to incur the upfront time and cost of implementing a hard stapled policy and more will push the cost further down the road by offering bidders an NBI report and leaving the preferred bidder to incur the time and cost of negotiating the policy."



Coverage Between Sign and Close

We are seeing a larger percentage of deals structured with a gap between signing and closing and expect regulatory, competition and NSI clearances to drive more deals to follow this trend. From a W&I point of view the gap between sign and close raises a question around coverage in the interim period:

i) if the warranties are only given at signing, then they will be covered at signing; and

ii) if they are given at signing and closing, then they are covered at both signing and closing subject to the following key point.

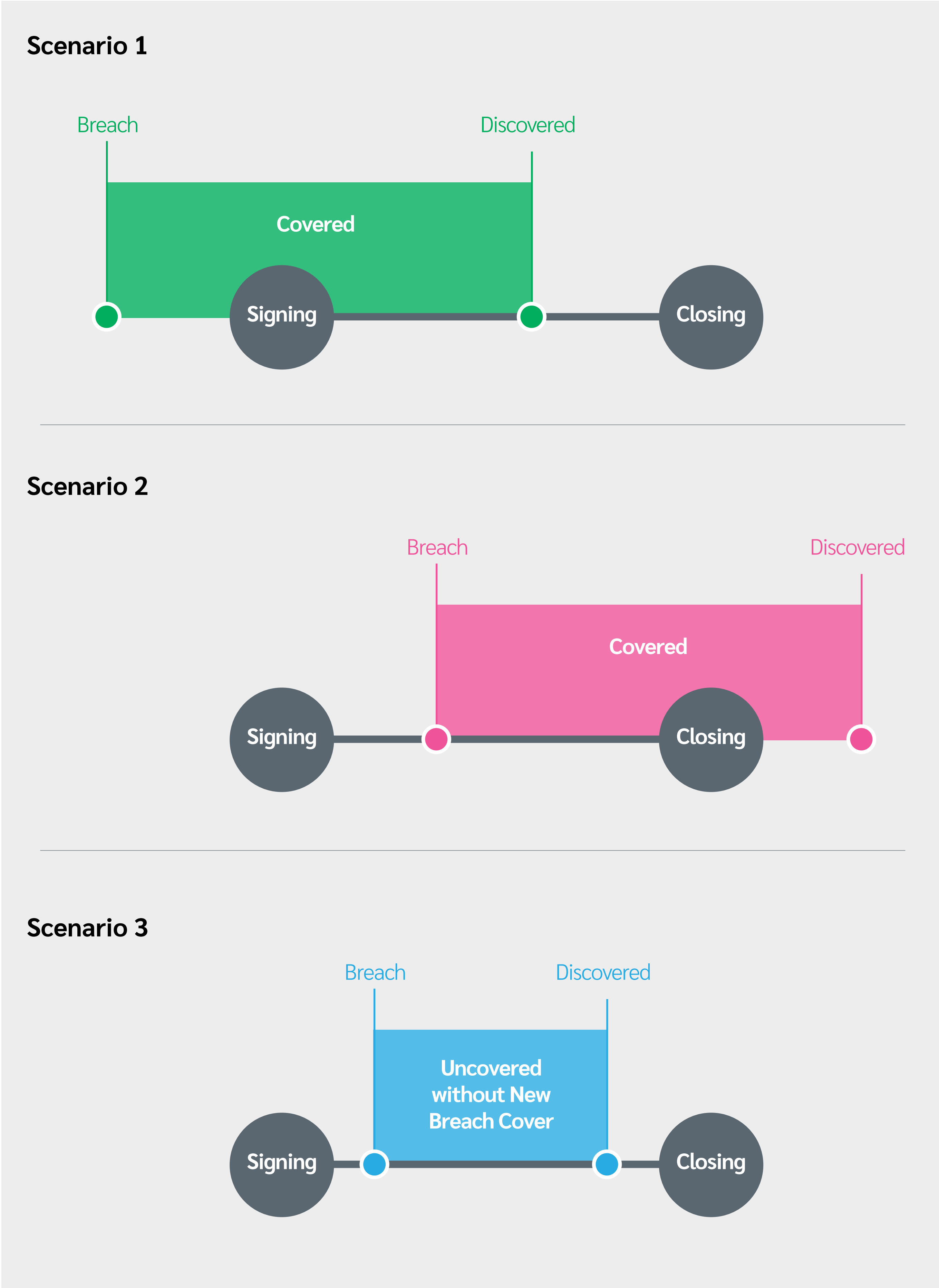
The key point from a W&I perspective is that there must be a bring-down/supplemental disclosure exercise from the seller/warrantors in relation to any warranties given at closing. Without this, the insurer would be covering potentially known events that are within the parties' knowledge having occurred in the interim period.

So as long as this updated disclosure occurs, then the closing warranties can be covered when repeated.

The coverage for this gap between the sign and close is what we would consider partial. Here's what you can expect:

- If a breach occurs prior to signing and is discovered between sign and close, that will be covered.
- If a breach occurs between signing and closing and is discovered after the close, that will be covered.
- If a breach occurs between signing and closing and is also discovered between signing and closing, that will not be covered therefore the coverage is considered partial.

A limited number of W&I insurers offer a form of "new breach cover" to plug the gap of this last point but appetite for this is fairly limited and is only obtainable on certain transactions.



Due-Diligence Requirements

As W&I plays an ever more pivotal role in M&A transactions, the question is often asked from both buyers and sellers around the DD requirements that insurers will expect to see for a deal to be insurable. The old adage of any warranty that has been given will be expected to be diligenced still holds true, but the scoping and materiality of DD is more and more being driven by insurer rather than buyer expectations.

Rebecca Bothamley, Partner at Mayer Brown and advisor to a number of key W&I insurers explains "insurers do still expect a full suite of diligence – financial, tax, legal (which comprises the minimum expectation), as well as insurance and anything else 'relevant' which increasingly includes EHS, IT, technical and regulatory diligence." An area that often proves a tension point is in international deals where Buyers have taken a decision to only diligence material jurisdictions. While this can make sense commercially it will leave a gap in the W&I coverage as underwriters are unable to take on risks that they haven't been able to review or quantify.

A question that is often asked is how insurers view internal due diligence. A few years back insurers would generally not quote a transaction without a full suite of third-party due diligence. Now, as Bothamley explains, "insurers will accept internal diligence, particularly in relation to some elements of legal diligence, provided they understand who the individuals are that are reviewing the documents and their relevant experience. As an example, a lot of corporates who have their own internal contracts team are often best placed to review customer and supplier agreements as it's something they do every day."

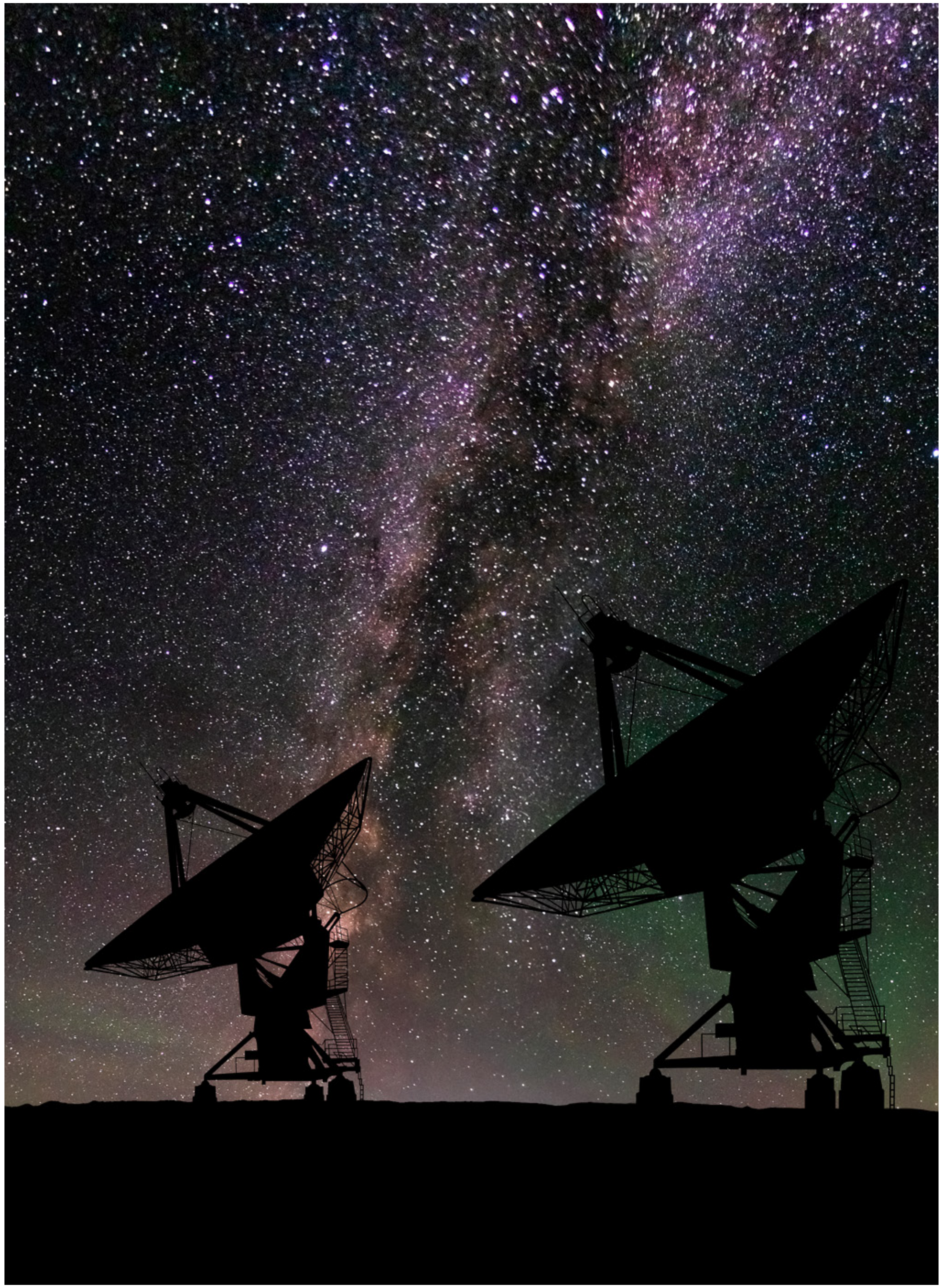
This movement in approach will generally only apply to legal or specialist DD and only when it is carried out by a qualified individual and reported in the format of a third-party report that insurers can review. It is very rare for internal tax or financial DD reports to be accepted by insurers.

Red-flag DD reports are generally accepted by Insurers and are now commonly seen on transactions. Bothamley notes that from a process point "it's still helpful to have some form of explanatory introduction for each section of the diligence so that the insurer understands the context of the red flags identified; otherwise, that often leads to more questions and back and forth during the underwriting process."

If an extensive vendor due diligence exercise has been undertaken underwriters can be open to a conversation around how much top up diligence the buyer must do for them to get comfortable.

"Insurers will accept internal diligence, particularly in relation to some elements of legal diligence provided they understand who the individuals are that are reviewing the documents and their relevant experience."

Rebecca Bothamley, Partner at Mayer Brown



Utilising Insurance on Distressed Deals

The transactional risk market responded swiftly to the potential for distressed deals following the pandemic lockdowns, however the expectation of a rise in enquiry flow in this space has yet to materialise. As we enter a period of increasing volatility in regard to energy pricing, interest rates, workforce issues and other macro-economic headwinds it is likely that more companies will run into financial difficulties. Lockton Transactional Risks placed the first synthetic warranty package in the market back in 2014 and has since been a leading contributor to the evolution of the product offering for distressed deals.

Whilst traditional W&I insurance is preferable on these transactions, the reality of a lack of DD, compressed timetables and a significant disclosure regime can mean that traditional cover is not possible.

Lockton Transactional Risks has agreed-form policies with several markets for a synthetic warranty package for deals where sellers are unwilling or unable to provide coverage. Whilst these are likely more expensive than traditional W&I and possibly less fulsome in scope, we have helped investors utilise them on a large number of transactions where insurance has unlocked the negotiations and provided comfort and a successful outcome for all parties.

Appetite for synthetic warranty packages will vary. The traditional factors of geography, size of business, asset class, scale and parties all play a part but insurers will need to get comfortable with the turnaround plans from the buyer as well as buy into the story of the underlying positive fundamentals of the business that is being traded. Targets that are struggling against a long-term macro shift in business such as bricks and mortar retail will struggle to obtain coverage without a convincing turnaround plan and positive future outlook. Insurers will be particularly interested in contracts, supply chains and employment risks on distressed assets.

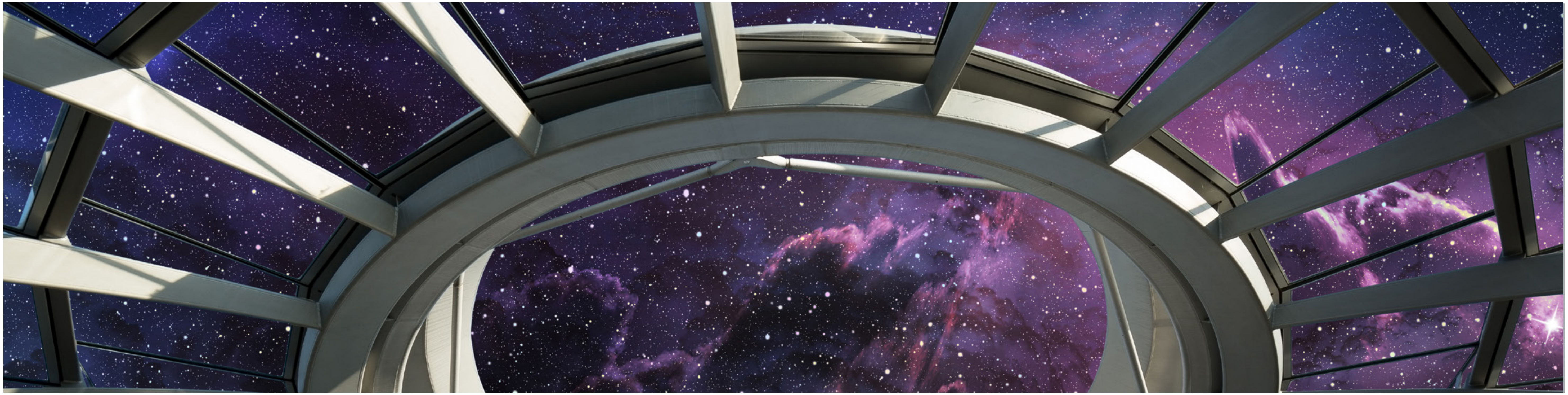
Whilst synthetic warranty packages are available for pre-packs or when a company is in liquidation, appetite is greatest before any formal insolvency proceedings have begun. Insurers look favourably at the ability to change an asset to a going concern and the involvement of management to provide disclosure. When an asset has reached liquidation or receivership, insurers will need comfort on the lender and creditor and are more likely to provide coverage on an asset deal. When it comes to a pre-pack transaction the swift timetable can be challenging to obtain insurance in the time-frame but some insurers view the involvement of administrators favourably in regard to the information flow that is needed to provide coverage.

To provide a synthetic policy, insurers will rely on adequate Buyers Due Diligence. For the agreed synthetic policies that Lockton Transactional Risks have created, a scope of required DD for each underwriter is also in place. Insurers will also look for a well populated data room and the ability to question those with knowledge of the business via a Q&A process.

The coverage position in synthetic policies is likely to be less fulsome than traditional W&I insurance. Areas that are easily diligenced such as title and capacity, assets, contracts, IT/IP, litigation, employees and accounts will likely be covered while areas that are harder to diligence such as information sweepers, recoverability of debts, financial performance since account dates or maintenance of records may be harder for insurers to provide coverage for.

Although pricing for synthetic warranty packages remains higher than traditional W&I, the competition from underwriters has reduced pricing so in some instances it is merely a few basis points off standard W&I.

We have also seen several contingent policies (see page 24) placed on distressed transactions where the ability to provide certainty on areas such as regulatory permissions, correct use of furlough schemes, IP or litigation risks has played a fundamental role in the transaction.



Structuring Real Estate Deals

Real Estate transactions continue to commonly utilise transactional risk products to de-risk the deal for both buying and selling parties. Real Estate investors are commonly utilising insurance in the following ways:

Structuring Real Estate Transactions

General

- The vast majority of corporate real estate transactions continue to be backed by W&I insurance with Seller liability for all claims under an SPA (including general and fundamental warranties as well as claims under the tax covenant) being capped at £1 cap. Having W&I in place on CRE deals is, in the view of our clients, very much the expectation as sellers continue to benefit from a clean exit on deals and both parties save time, costs and potential tension negotiating the warranty suite.

Title

- Title insurance remains popular, with standalone policies being preferred to fundamental warranty top-up insurance. The standalone policy is often significantly more cost effective and the scope of the insured risks under a title to shares or real estate policy being far broader and comprehensive than the scope of the fundamental warranties contained in an SPA.
- We've also seen an increased use of low-cost specific risk title insurance being taken out to plug gaps in the property exclusions under a W&I policy.

Certificate of Title Top-up Insurance

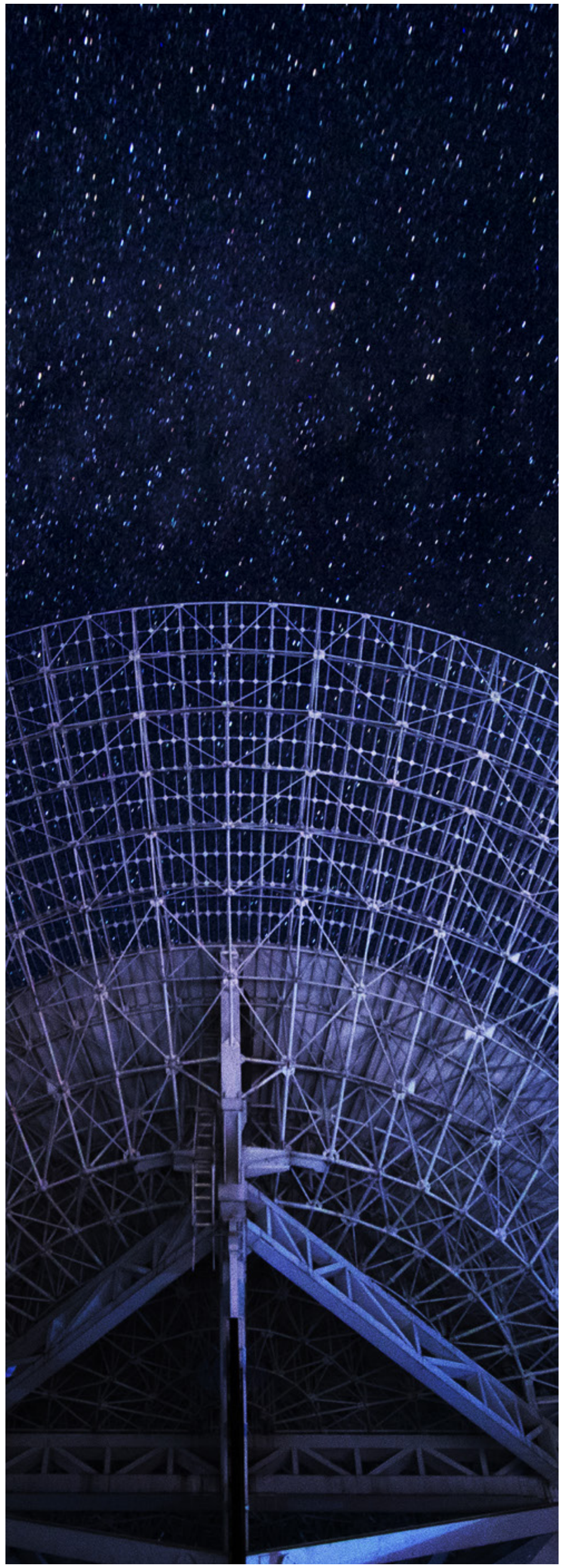
- We've had a significant increase in enquiries around utilising insurance to plug the gap between the liability cap offered by selling parties under the CoT and Buyers expectations on protection. Lockton Transactional Risks has developed a new CoT Insurance product which is designed to top-up the liability offered under a certificate of title to either the full purchase price on an acquisition or the full facility amount (plus a buffer) in the context of a refinancing. We've found that there is considerable scope for negotiation in respect of what is covered under these policies and we'd be happy to discuss in more detail if helpful.

12%

Percentage of corporate real estate deals include title insurance policies

£1 cap

Corporate real estate transactions continue to be backed by W&I insurance with Seller liability for all claims under an SPA cap



Tax Risks

Mathew Bond
Head of Tax

The art of the possible is driving growth in the tax insurance market.

The growing knowledge around the availability of tax insurance as well as the increased education in the art of the possible of what can be achieved with the product has driven an increase in demand for policies over the last 12 months. We anticipate this trend to continue the more familiar clients become with tax insurance policies. Any perceived uncertainty around the lasting impact of the global pandemic did not slow the demand for the product, with growth being driven predominantly by an increase in transactions.

The environment continues to be competitive with insurers further bolstering their teams and the resulting battle for market position has resulted in a further pricing reduction compared to the prior year. This reduction has been made possible by a relatively static number of claims across the market with the savings made as a result being passed on by insurers through lower pricing. It is anticipated by insurers that any further reductions to the pricing are unlikely as there is an expectation that claims activity will pick up in the next 12 months which will drive pricing higher on future policies.

Internationally the location that has seen the most rapid growth in coverage has been Spain – this trend is heavily driven by the number of insurers increasing headcount with new hires locally. Trends in the types of coverage sought over the year weigh heavily towards the potential tax implications driven by transactions in both the technology and real estate space.

Premium pricing for tax risks in the round are attracting rates typically between 1% to 5% of the policy limit, depending on the nature of the risk, the technical analysis, and the jurisdiction.

Irish Stamp Duty

We were approached with an Irish Stamp Duty Tax Risk in relation to a series of transactions regarding a hotel in Ireland that was ultimately being sold for EUR80m. The risk was in relation to the interpretation of the sub-sale relief position and how it would apply to the transaction. Advisors on either side of the transaction had conflicting views on the matter hence the uncertainty as to whether sub-sale relief would apply. If sub-sale relief was to be successfully challenged by the Irish Tax Authorities the expected exposure including interest, penalties and Stamp Duty would be in the region of €15.1m and therefore would be a significant cost and would derail the transaction if not insurable.

We negotiated and agreed a tax policy to cover the full limit and the resulting premium paid by the insured was EUR220k.

UK ERS

A manufacturing business looking to sell its entire share capital for cash consideration of c.£130,000,000 approached us in relation to an employment related securities issue. The issue being a loan from a director to the company of £500,000 was converted into 500,000 deferred £1 shares. The intention being that the deferred shares only be entitled to a return of the nominal value paid up on the shares. However the formal documentation did not fully reflect the position. This gave rise to an issue meaning it could be argued the deferred shares would rank pari passu with the remaining shares in issue - this would entitle the director to a significant windfall on exit as the shares could be argued to equate to 84% of the company.

If HMRC were to successfully argue the deferred shares ranked pari passu then UK income tax, PAYE and NIC would be payable because the deferred shares would be treated as employment related securities acquired for less than market value. The total tax at stake would mean additional taxes of circa £60m, which if not insurable would have meant the transaction could not proceed.

The policy was placed to cover the full amount with a premium of £1.2m.

Spanish CIT

A Spanish real estate investor approached us to assist with a transaction involving the sale of their EUR850m student accommodation business to a pension fund. The risk we were asked to place was centred around the Spanish tax authorities being able to determine that certain management fees were not allowable deductions in calculating the taxable profits. If the Spanish authority successfully challenged the position, the corporate income tax and VAT repayable to the authorities would be €28m.

We placed a policy for the full exposure and the insured paid a premium of €425k to secure the policy.

1-5%

Premium pricing for tax policy limit rate

15%

Percentage of transactions include standalone tax policies

Contingent Risks

Alexander Rayner
Head of Contingent Risks

The nascent market for contingent and legal risk insurance has continued its growth, with client awareness of the product growing and an increasing appetite from insurers to underwrite contingent risks.

From its early days as a market to service issues identified in the M&A context, the last year has continued the trend of parties exploring contingent risk policies throughout the business cycle. Clients are now exploring using contingent insurance solutions to assist with a variety of issues, including fund wind-ups, removing historic deal liabilities from balance sheets and ring-fencing issues in advance of transactions.

High limit and value driving contingent risk and legal policies placed in the last year have increased confidence and enthusiasm about the product among corporates, deal advisors and insurers. The growing interest of insurers in the space is reflected by the hiring of dedicated contingent risk underwriting teams at leading insurance markets, which has increased competition in the marketplace and the availability of insurance solutions for contingent risks. By hiring technical experts in the fields of litigation, accountancy and IP, insurers are able to underwrite increasingly complex risks and provide sophisticated insurance solutions.

Although pricing for contingent risks is still significantly higher than for other transactional risk products, typically in the 5%-12% range, this reflects the significant value that can be generated for insured parties by taking out contingent risk insurance policies. We expect pricing to remain high for esoteric and complex risks, but pricing for less complex risks that insurers have begun to gain experience of underwriting is likely to fall. We would expect indicative pricing of between 3-8% for low to medium and less complex risks, with pricing >8% for high or more complex risks.

We expect to see further expansion in the contingent and legal risk market over the coming year to match the growing insurer appetite and increasing client awareness of what can be achieved.

Insuring the Secondaries Market

With IPOs down 46% in 2022 on a year on year basis (EY), and, M&A exits affected by rising interest rates with H1 2022 down 20% vs H1 2021 (PwC), the number of attractive exits for investors are diminishing. For trophy assets held in funds, it presents a conundrum of how to deliver fair value to their Limited Partners many of whom are under a liquidity squeeze. These issues combined have led to a spike of GP-Led Secondaries. With $125bn expected to be raised by funds for investment in the Secondaries sector and 47% of that expected to be deployed in the GP-Led arena, significant activity is anticipated for the remainder of 2022 and 2023.

Why W&I in GP-Led Secondaries

GP-Led Secondaries have come under the microscope in the US, questions regarding valuations and also the inherently complex role of the GP has meant insurance has already played a valuable role in the US Market and hence is anticipated to transfer to the UK and European markets. By using W&I, investors benefit from a deal-review by an experienced third party, which may raise queries as to the deal and deal structure. As in an M&A transaction, W&I also ensures that selling/rolling LPs are not required to leave funds in escrow in respect of potential liabilities, as these will be covered by the W&I policy. Lastly, and importantly, it provides a method for recourse for investors, in a relatively small market where maintaining good relationships is of key importance for future investments.

Hybrid Warranties

As the market has grown, we have seen an increasing propensity for M&A Buy-Out style warranties to enter into GP-Led Secondary transactions.

Traditionally, Secondaries transactions were considered to be transactions at a purely financial level, between sophisticated financial investors. Due Diligence and Purchase Agreements reflected this, with legal DD limited to largely evidencing solely Fundamental Warranties (title, ownership, laws, conflicts) and provision of financial fund performance data. However, we have seen a shift and there is often more of a blend between traditional secondaries warranties and M&A warranties - a "hybrid" warranty package.

Benefits of insuring secondary deals

Deal-review by an experienced third party	No escrow for Exiting/Rolling LPs	Recourse option that maintains relationships between LPs/GP

In general, insurers will require every warranty to be properly diligenced. However, in a GP-Led transaction, access to relevant Portfolio Company's Management Team's might be limited and therefore sufficient information may not be available. This frequently leads to such "hybrid" warranties being qualified to the knowledge of "the GP and the GP's enquiries of management." The value of such "hybrid" warranties, once qualified, should be closely questioned by investors both in terms of actual benefit and potential affect and delay to deal execution. This situation may be different where there has been a minority stake sold via traditional M&A, such that the DD already exists, or, where it is a single-asset GP-Led and management of the underlying Portfolio Company may be more involved.

Premium Pricing

Premium prices in the UK and EU represent significant value when compared to US deals. Lockton has delivered ranges from 1.2–1.6% of purchased limits depending on the underlying assets.

Excluded Obligations

Another key area where W&I can assist GP-Led transactions is providing cover for EO's, in particular LP Clawbacks. These can be a sticking point in certain GP-Led Secondary transactions. By obtaining this coverage, LPs can be freed from potential liability arising under the Clawback provisions of the exited Fund. Fund performance is a key factor to obtaining such coverage.

Who is Covered?

Another trend that we have noted is W&I only being taken by the new investors, which we estimate to have been around a quarter of GP-Led policies placed. This reduces the Retention (or excess) required prior to any claim, so represents a benefit to new investors. However, this does create an imbalance in initial transaction cost for rolling LPs vs new investors, as well as potentially a significant imbalance should a claim be made, with only the new investors covered.

Growth of Market

As the coverage of GP-Leds has become more commonplace in the US, the number of markets offering coverage for GP-Leds in London has significantly increased. Lockton are now able to confidently place GP-Led transactions with significant NAVs in the UK and European markets.

Insuring Tech Deals

Tech transactions account for many insured deals, particularly with the high deal volumes in the space seen over the last two years. These transactions carry with them certain nuances from an insurance point of view which should be considered from the outset.

Insurers will be particularly interested in the following areas:

- Valuation methodology especially regarding new products or new business units
- Cyber risk and ransomware
- Ability of software to migrate to a new product
- Ownership of coding particularly regarding open source or contractors
- Findings from software composition analysis audit reports

Cyber and Technology

Cyber risk are unlikely to be covered by the W&I policy and insurers will expect to see standalone cover for this, particularly if a company holds a lot of GDPR regulated data.

Organisations must demonstrate reliability in maintaining robust cyber security, particularly when it comes to the use of data. The risk of data being stolen, tampered with, or destroyed, threatens the very heart of the sector.

Where appropriate, risk transference by way of cyber insurance will complement a healthy cyber programme. The maturation of the cyber insurance market, commensurate with the increasing sophistication of cyber-criminals, means that a standalone cyber policy may be required as part of a cyber risk profile.

Typical cyber coverages in a market-leading policy include:

First-party coverages:

- Breach event costs
- Business interruption loss
- Cyber extortion
- Digital asset loss

Third-party coverage:

- Privacy liability coverage
- Privacy regulatory liability (to the extent insurable by law)
- Media liability coverage

Intellectual Property

A full analysis of the Intellectual Property (IP) risk and a consideration of appropriate protection of these intangible assets is recommended. IP risks that have been flagged in due diligence may also be covered off by insurance. Such risks can relate to:

- Copyright
- Trade Marks
- Designs
- Patents
- Trade Secrets

A full analysis of the Intellectual Property (IP) risk and a consideration of appropriate protection of these intangible assets is recommended.

Recent Tech Deals

MailManager
Buyer – Ideagen
Sellers – ARUP
EV – £26.4m
Jurisdiction - UK

YourParkingSpace
Buyers – Flowbird Group
Sellers – Pelican Capital
EV – £120m
Jurisdiction – UK

Context
Buyers - Integral Ad Science
Sellers – Undisclosed
EV – Undisclosed
Jurisdiction - France

Insuring Business Services Deals

The Business Services sector comprises both tech-enabled business service providers and more traditional professional services firms. Whilst the volume of Business Services transactions is down slightly from 2021, the sector continues to be dominant - together with TMT transactions, it accounted for 60% of mid-market private equity deals in H1 of 2022.

Given the breadth of the sector, underwriting focus will depend to a degree upon the nature of the services being provided. Nonetheless, there are some general areas of focus, including:

- cyber risk;
- personal data and GDPR;
- sufficiency of the target's IT system;
- AML and ABC (particularly if the target operates in, or derives revenue from, higher risk jurisdictions);
- where relevant, the target's compliance with any regulatory regimes or professional rules to which it is subject; and
- material contracts, particularly where a small number of customer contracts comprise a material portion of the target's revenue.

For tech-enabled business services providers, there will be a degree of crossover with the underwriting focus for more general tech businesses (see page 28 for more details).

On transactions involving professional service providers, insurers will typically insist on a general exclusion covering professional indemnity and service/E&O liabilities, as the expectation is that these should be covered under the target's PI insurance.

Recent Business Services Deals

CTI Digital
Buyer – LDC
Sellers – Undisclosed
EV – £25m
Jurisdiction - UK

3173 Group
Buyer – Synova Capital
Sellers – Undisclosed
EV – Undisclosed
Jurisdiction – Ireland

Kpler
Buyers – Insight Partners and Five Arrows
Sellers – Undisclosed
EV – $200m
Jurisdiction - Brussels

Insuring Hotel Deals

Hotels have been reported to account for 10% of all real estate transactions in recent years and we have seen a large increase in transaction flow post lockdown easings.

When placing W&I coverage on a hotel deal there are key considerations that should be considered. Hotels are often structured by means of an OpCo/PropCo which means that:

a) The property-owning company owns the property assets of the transaction

b) The operating-owning company owns the operating assets of the transaction that are used to generate revenue

From a W&I perspective the OpCo aspect is treated differently from the PropCo part of the transaction. For example, the PropCo can be sold separately from the OpCo during an exit but both are also treated differently by insurers as follows:

PropCo

Rates	Retention	Environmental
Rates: 0.6% of sum insured	Nil retention	Main focus on Environmental matters

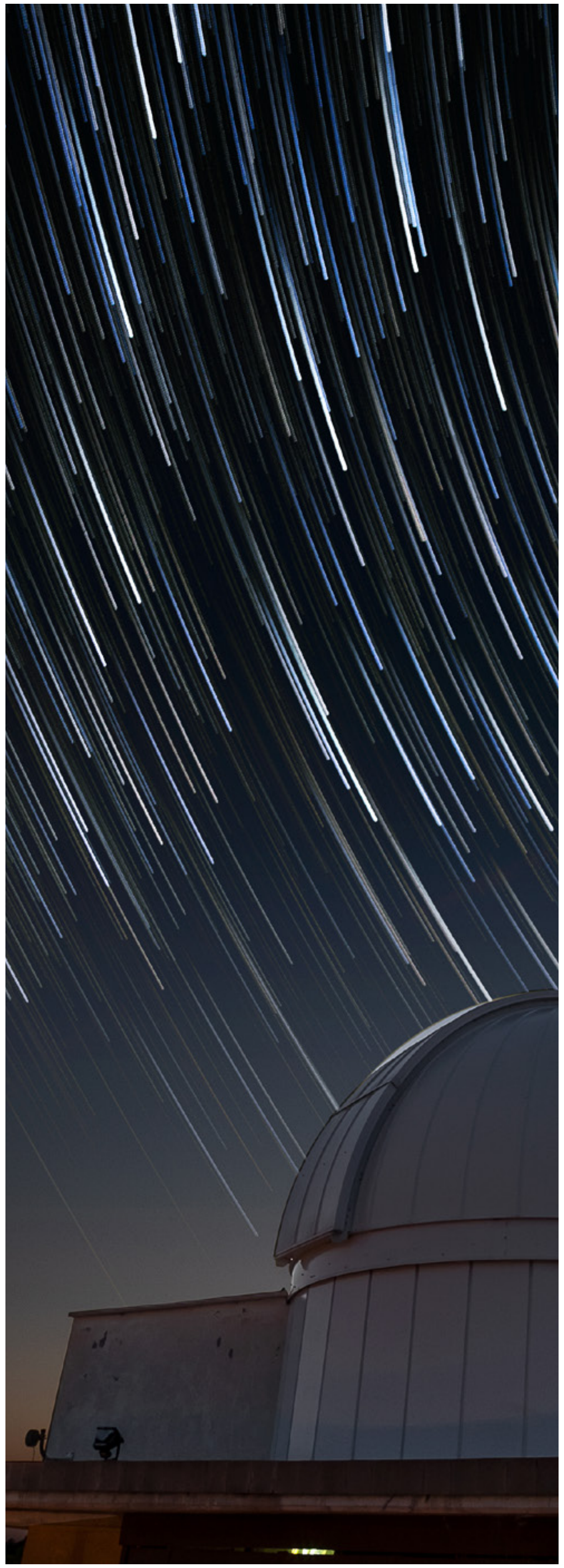
OpCo

Rates	Retention	Employees	Payroll
Rates: 0.72% - 0.95% of sum insured (subject to jurisdiction)	Lowest retention – 0.25% (with option for tipping to Nil)	Higher scrutiny on employees and contractors (holiday pay, pension underfunding, misclassification of employees)	Payroll and wage tax liability

Typical exclusions on a W&I policy on an PropCo / OpCo deal include:

a) Condition Defects for the PropCo

b) Cyber / GDPR for the OpCo



Recent Hotel Deals

QO Hotel
Buyer – Tristan Capital Partners
Sellers – Invesco
EV – €92.1m
Jurisdiction – the Netherlands

Hotel Brooklyn
Buyer – CDL Hospitality
Sellers – Roundapple Hotel Partners
EV – £24m
Jurisdiction – UK

Hard Rock Hotel
Buyer – Arlaes Management
Sellers – ActivumSG Capital Management
EV €65m
Juridiction – Spain

Insuring "Living Deals"

The "living" sector has been particularly buoyant over the last few years with investors increasingly attracted to transactions in BTR, Student Accommodation, Single Family Rental and Care Homes. Lockton Transactional Risks has a wealth of experience in this space working alongside our market leading healthcare and real estate and construction team to assist investors in not only de-risking their deals but also protecting their assets going forward.

From an insurance perspective investors in this space should be aware of certain nuisances:

Operating Real Estate

Often transactions in this sector will involve a portion of operational risk where investors are taking on the liability of employees and other operational liabilities. This can attract additional premium rates to the deals and investors should look to how to maximise the best insurance premiums on the operational vs property sides of the business as discussed in our hotel segment on page 32.

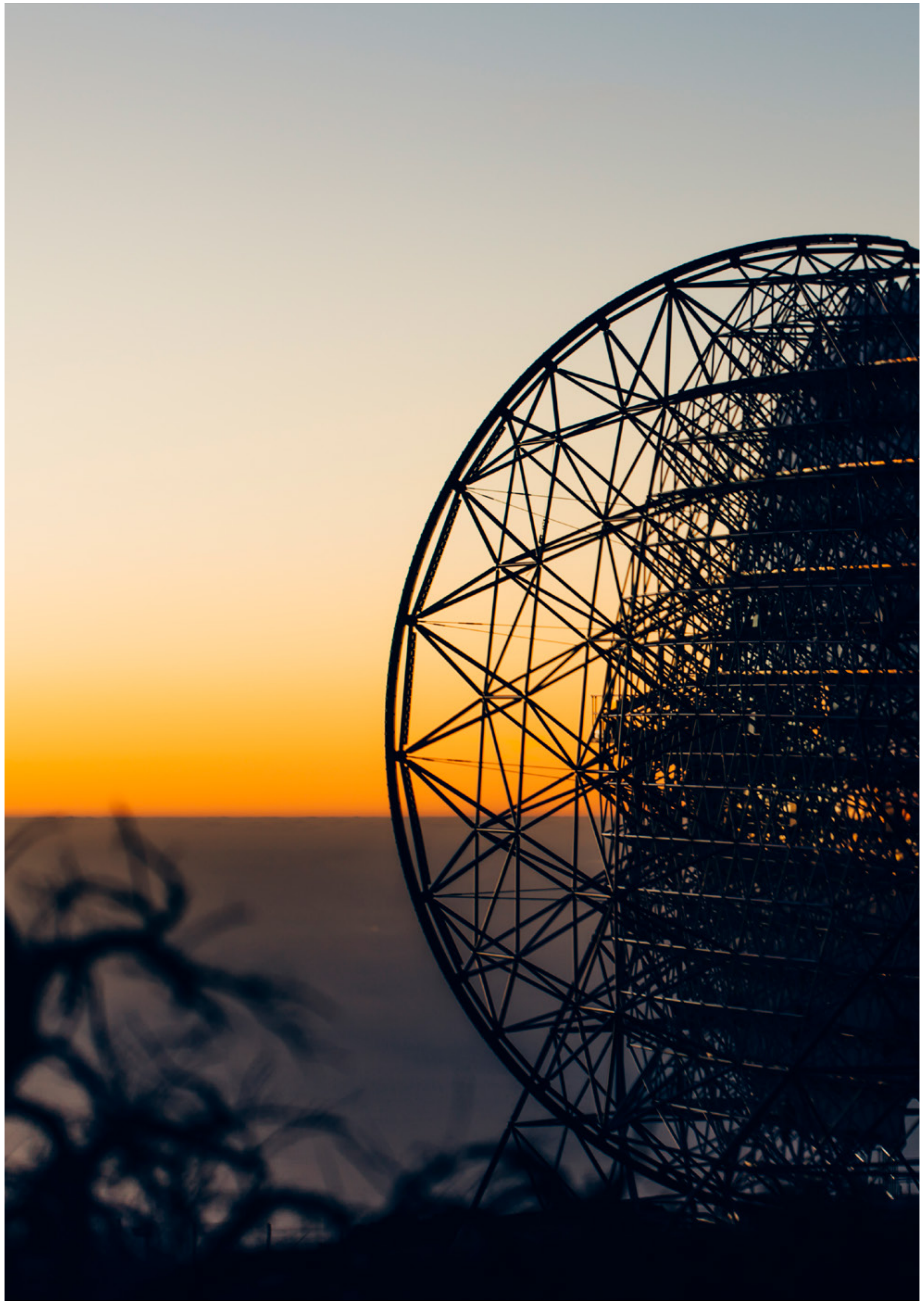
Development Risk and Forward Purchasing

Often investors in this space are looking to forward fund or forward purchase a transaction and hence take on a potential development risk. We recently worked with a large North American real estate investment firm in regard to a forward purchase of a multi-family development in the UK. In contrast to an outright purchase, the acquisition saw the client exchange and partially fund the development of the properties. Therefore, completion for these deals occurred at a much later date post exchange.

Standard W&I deals typically see interim periods of one to six months, with insurers asking for additional due diligence for longer periods. The transactions in question had an exchange date, a conditional date requiring the Seller to satisfy a host of conditions regarding the property and the completion date. The unique aspect for W&I here is that the conditional date could happen anywhere from 6 months to a year following exchange, but the client wanted coverage from the date of exchange.

Working alongside the client's law firm, Lockton Transactional risks structured a tailored solution where the policy went on risk at exchange, as the client desired, while ensuring the insurer was comfortable with the risks given the long interim periods between exchange and completion.

The team was able to negotiate and design a standardized W&I solution to be used on all acquisitions by this client which would streamline the process for all future deals.



Recent "Living Deals"

Virtue Group Care Homes
Buyers – Emera
Sellers – Undisclosed
EV – Undisclosed
Jurisdiction – Ireland

Student Accommodation Portfolio
Buyers – Quadreal
Sellers – RealStar
EV – £750m
Jurisdiction – UK

Student and Co-Living Portfolio
Buyers – Undisclosed
Sellers – Undisclosed
EV – £112m
Jurisdiction - UK

Insuring Renewable Deals

The Lockton Transactional Risks team has extensive experience is assisting investors in the renewable energy space. The team has worked on large scale transactions across solar, wind, battery storage, hydro-electric and biomass deals internationally.

Whilst appetite for these deals from insurers is high there are certain areas of risk specific to these deals that investors should take into consideration in regard to transactional risk:

Environmental Risks

Environmental risks are a common exclusion under W&I insurance policies. With renewable deals underwriters are often able to take more of a pragmatic view when reviewing a clean phase 1 environmental report or when the target is a greenfield site. We have also seen underwriters able to remove this exclusion when the environmental liabilities are covered in the technical DD report.

The Lockton Transactional Risks team works closely with our dedicated environmental risk practice who work to provide insurance solutions to investors where a known environmental risk has been flagged in due diligence.

Development Risk

The condition of the purchased assets is another standard W&I exclusion but we have seen this exclusion removed when the project is in development stage and has no assets. Underwriters will want to understand which party is looking to take on the development risk. We have also seen contingent policies placed on renewable deals in regard to future loss of profits or judicial review of permits.

Subsidies

Often renewable investors are taking advantage of subsidies which can be the key differentiator regarding profitability of the asset. Appetite from underwriters to cover a loss of a subsidy is limited and hence it's important at the outset of underwriter engagement to make clear the subsidies that the asset receives or are anticipated to receive.

Tax Risks

Renewable deals are often structured with the benefit of certain tax assets. Capital allowances and trading/tax losses will often form a key part of the valuation of a renewable deal. Insurers will want to understand the impact of the non-availability of a tax asset and we often see these risks being covered in a separate stand-alone tax risk policy. Some underwriters are able to cover this point but only with visibility of specific tax diligence.

Recent Renewable Deals

Corbiere Renewables
Buyers – Bio Capital
Sellers – Downing LLP and Raynham Estate
EV – Undisclosed
Jurisdiction - UK

Photovoltaic Plants
Buyer – SR Investimenti,
Gianni & Origoni and Kiwa Moroni
Seller – Undisclosed
EV – €31m
Jurisdiction – Italy

Solar Installation plant
Buyer – Undisclosed
Seller – Undisclosed
EV – £3.5m
Jurisdiction - UK

Predictions

The transactional risk market remains incredibly buoyant, entrepreneurial, and innovative. While the tail end of 2021 saw a market in some instances struggling to cope with its own success, leading to capacity constraints, 2022 has seen a further maturing of the marketplace. Experts continue to join, bringing sector specific experience and driving innovation on new risk areas.

1) We predict ever greater use of contingent risk and tax policies as buyers push for greater certainty on risks in an ever-changing world. Tax structures will be under more scrutiny than ever, ESG risks will become an increasingly important issue and buyers will look to the insurance market to provide certainty for non-M&A risks such as regulatory reclassification or judgement preservation on a case. Paul Smith Head of W&I at Acquinex expects that “the market will continue to increase the sophistication of its product offering. There will continue to be strong interest in the take-up of transactional insurance policies tailored to the needs of individual insureds and this will prove to be particularly valuable to serial acquirers who will benefit from the increased efficiencies and certainties that these policies can deliver.”

2) Claims will begin to impact client’s view on different insurers – as claims frequency increases and more claims stories emerge, clients will become ever more aware of the response from insurers on claims and the role of a broker in claims-handling. While greater competition of insurers has generally led to positives of low premiums and wider coverage for insurance buyers, the merry-go-round of team moves within the underwriting space will lead to more established, solid teams with a long-lasting track record being more sought after by experienced dealmakers.

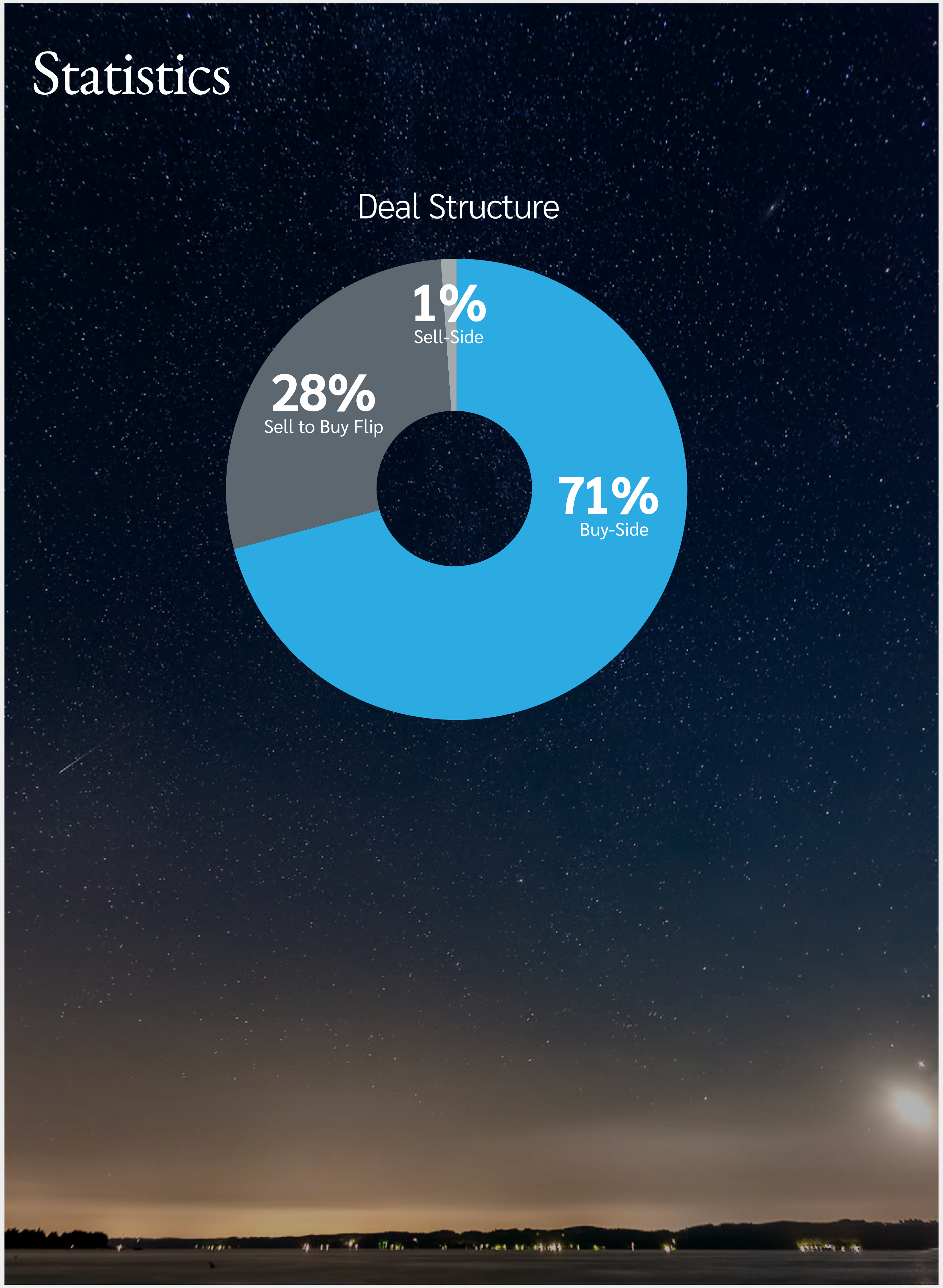
3) The W&I market has ridden a wave of a seller-friendly M&A market for the last seven years. As economic headwinds and political instability become more present, the ability of sellers to cap their liability at £1 may prove less accepted by buyers. Whether we return to the early days of W&I where insurance sat in excess of a seller’s liability cap or the product is now so well established in the deal tool-kit that £1 caps are here to stay, whatever the economic weather, remains to be seen. Paul Smith “expects macro driven short term funding constraints on PE to begin to impact deal demand and for this to continue across all jurisdictions until the end of Q1 2023 at the earliest. This will likely result in M&A moving from a sellers to a buyers’ market, valuation multiples to fall and consequently an increase in opportunistic strategic trade deals as trade buyers fill some of the void left by PE.”

4) Market penetration in emerging markets and across Europe will continue at pace. Insurers and broking firms continue to expand geographically, linguistically, within sectors and within deal sizes. Lockton Transactional Risks continues to expand its geographic scope across the UK, Europe, Asia and the US. Sector experts joining the market from backgrounds in oil and gas, FMCG and Financial Institutions continue to push the products capabilities in coverage for specific sector risk areas.

Energy is likely to be a particularly buoyant M&A market with Paul Smith commenting that he expects a “doubling down on private and state investment as security of energy supply and certainty of cost becomes the number one political priority. In particular, the increase in energy commodity prices has the potential to increase the viability of energy projects that may previously have been shelved for being too costly.”

Much innovation is also happening within the SME market with several insurers looking to the great volume of uninsured deals and creating products and technology to offer W&I solutions to these deals.

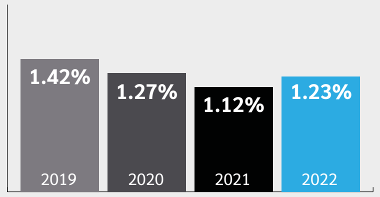
Statistics



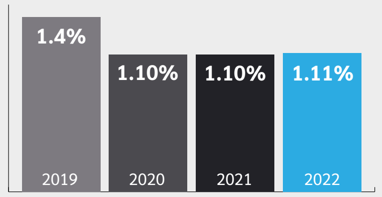
UK Premiums by Sector:

Premiums as a percentage of limit

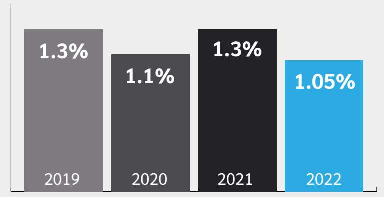
Automotive



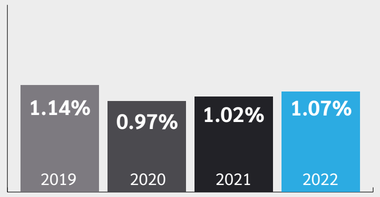
Financial Services



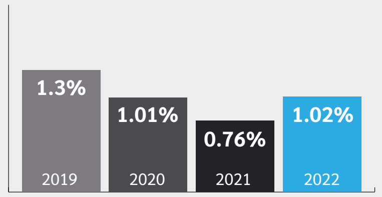
Transport and Logistics



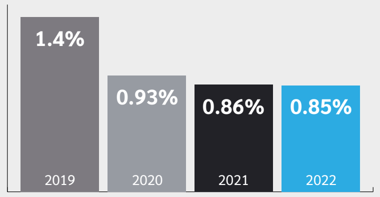
Leisure



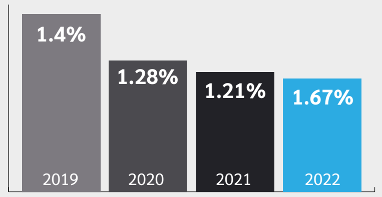
FMCG



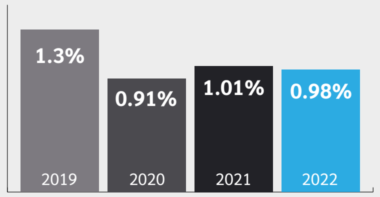
Business Services



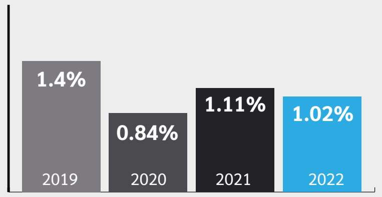
Healthcare



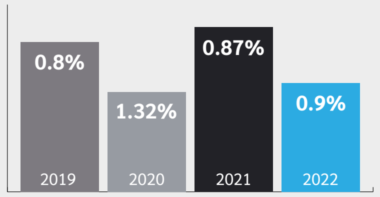
Education



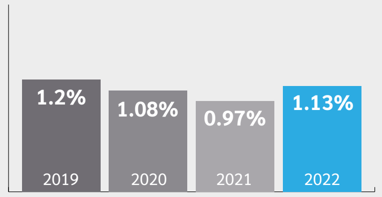
Infrastructure



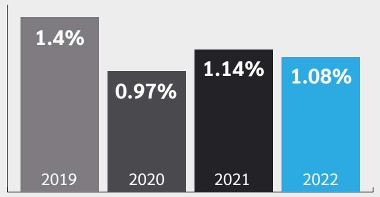
Energy



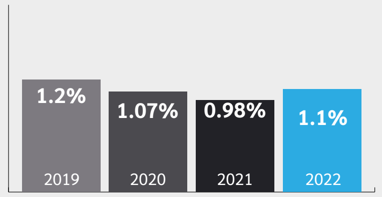
Manufacturing



Engineering



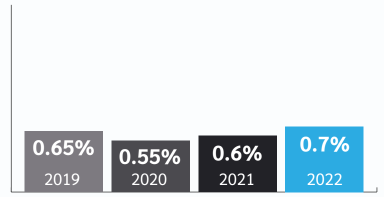
TMT



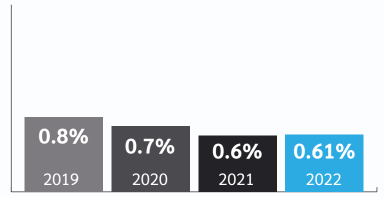
Real Estate

Industrial and Logistics

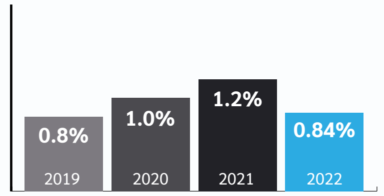
Office



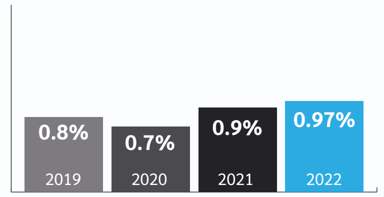
Residential/Student Accomodation



Retail

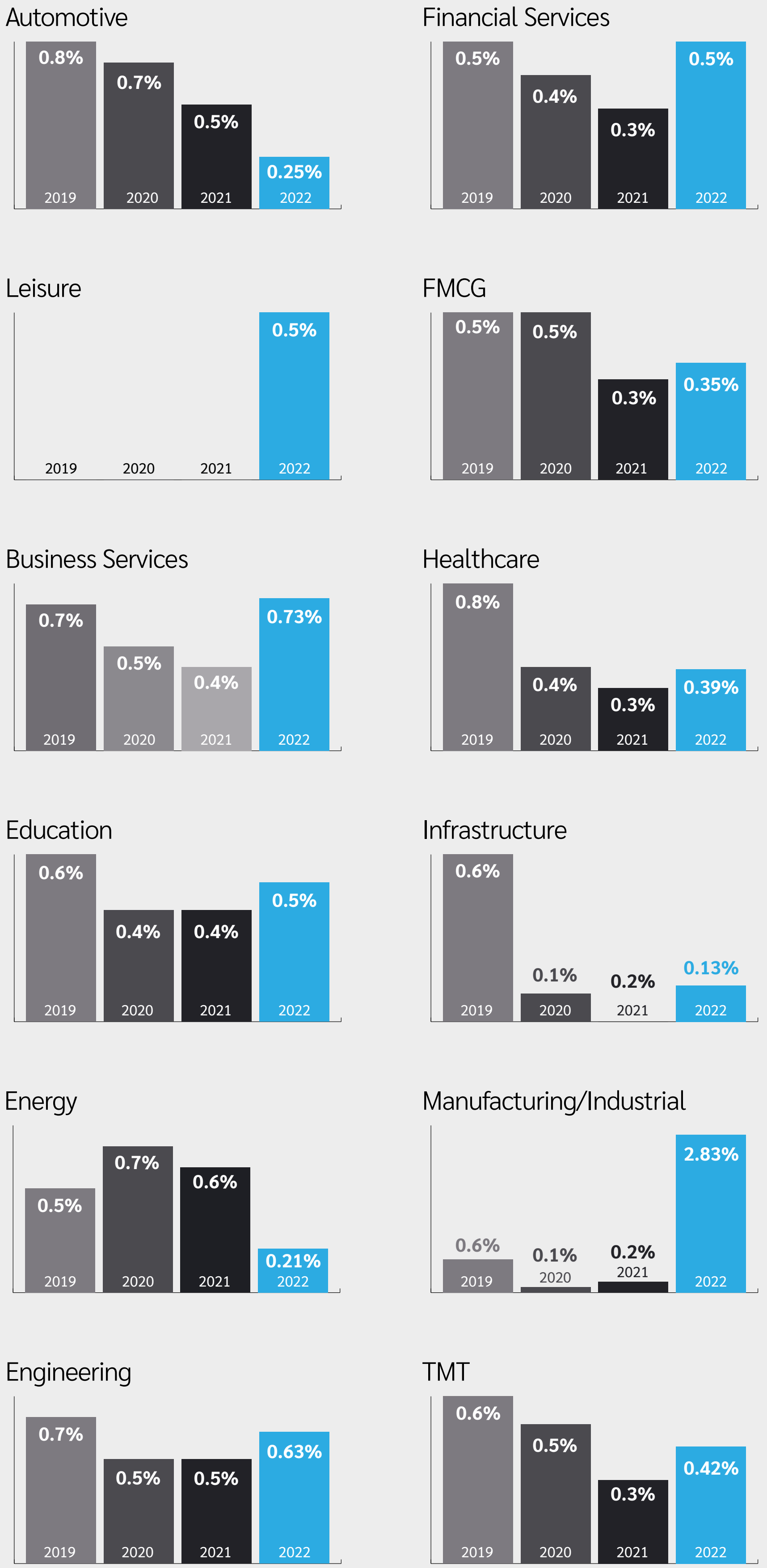


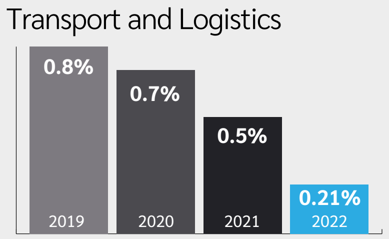
Hotel



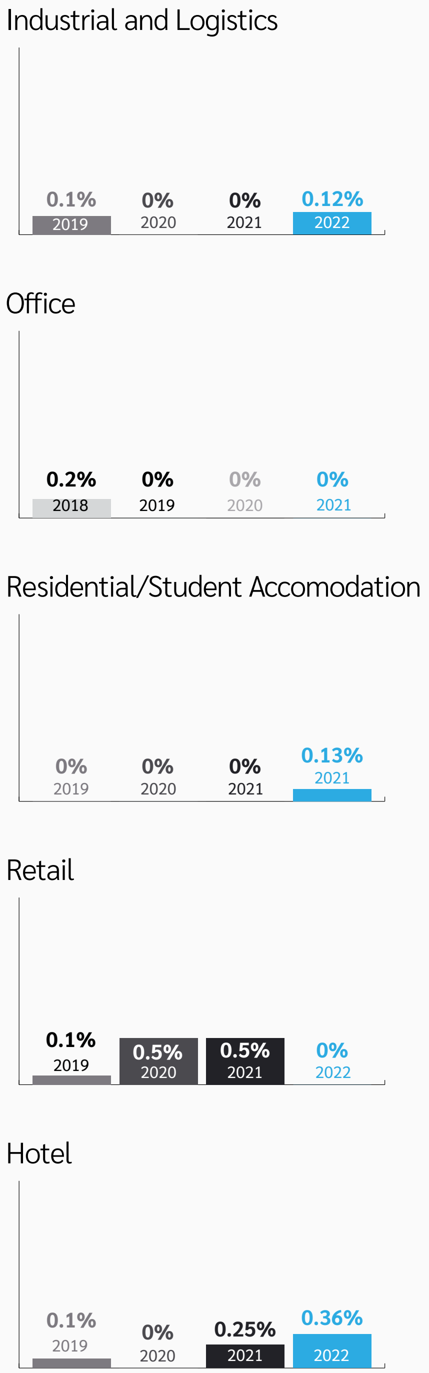
European Excess by Sector:

Excess as a percentage of limit





Real Estate



Average Premiums and Excesses by Geography

Claims

Claim notifications continue to increase year-on-year, but contrary to expectations insurers report that the uptick is not from Covid-19/lockdown related claims but simply due to the increased popularity of the product.

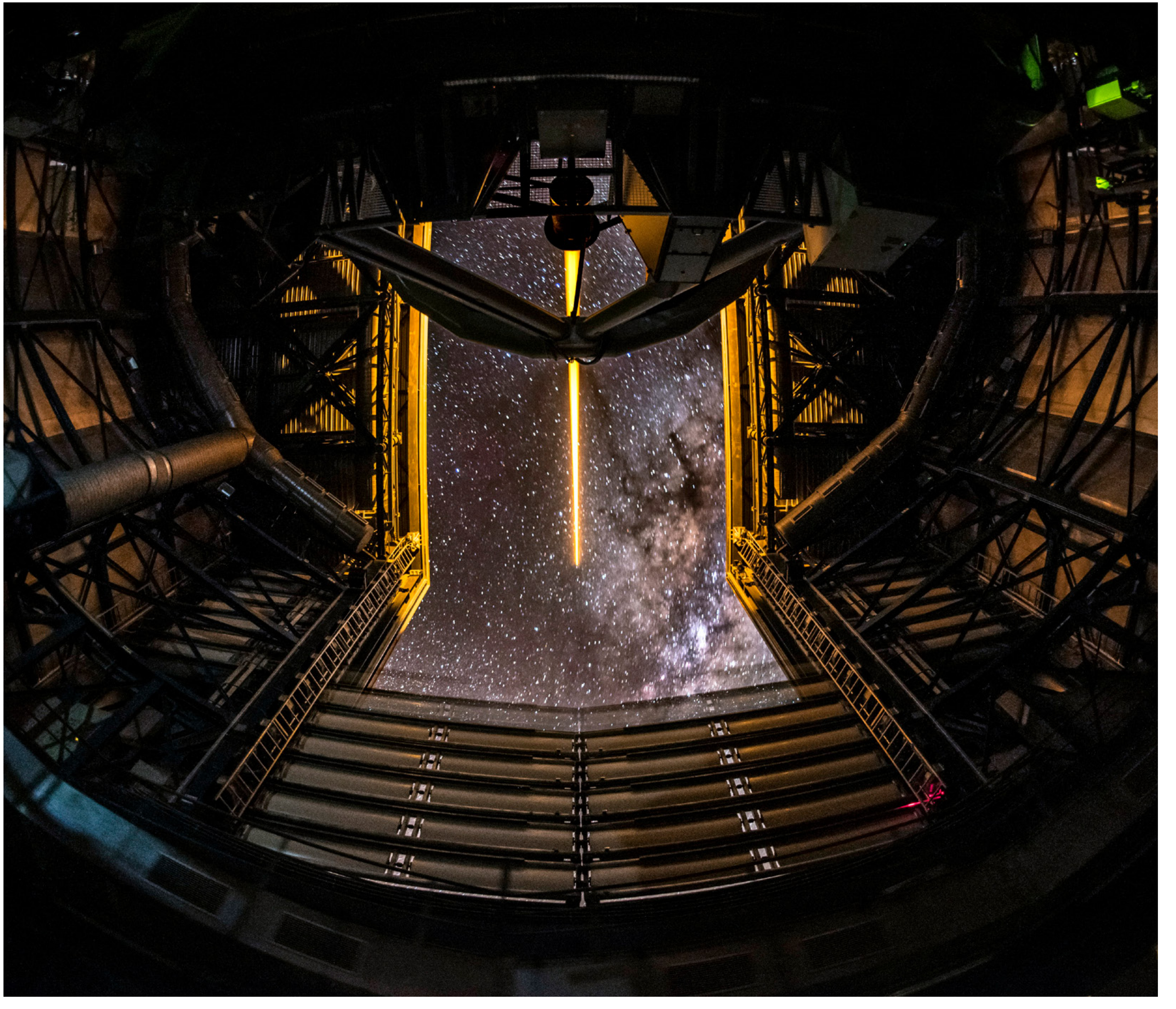
As the effects of lockdown begin to penetrate through the financial system, supply chain issues, inflation, labour issues and other financial headwinds are likely to lead to an increase in W&I claims. We expect to see an increase in claims relating to:

- Key customer or supplier insolvency
- Changes to material contracts
- Employment warranties
- Stock

Currently however, the most common breaches notified are in relation to warranties on tax, accounts/financial statements, and litigation. There have also not been any notable changes in terms of claim severity.

Insurers have a greater appetite to underwrite risks in the mid-market as opposed to deals on the smaller / larger end of the scale. This is because in terms of trends relating to deal size, we have seen that statistically the largest (£1bn+) and smallest deals (sub £30m) see the greatest number of claims globally.

The speed at which claims have been notified within the policy period however has been increasing. We reported about 65% of claims in recent years were notified within 12 months, a significant increase from the 49% figure reported in 2019. In terms of overall notification rate, studies have shown that the level is at around 20% globally which is up from 15% in 2019.



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