



M&A Insurance – The new normal?

This year's analysis of claims on AIG's representations and warranties insurance (R&W)¹ demonstrates that claims, both large and small, are likely to be a constant feature in M&A deals going forward. The insights in this report, which is now in its third year, are becoming even more meaningful to dealmakers as AIG's book of business continues to grow and the data bank builds. The claims in this study arise from AIG policies covering deals with a total value of over \$700bn.

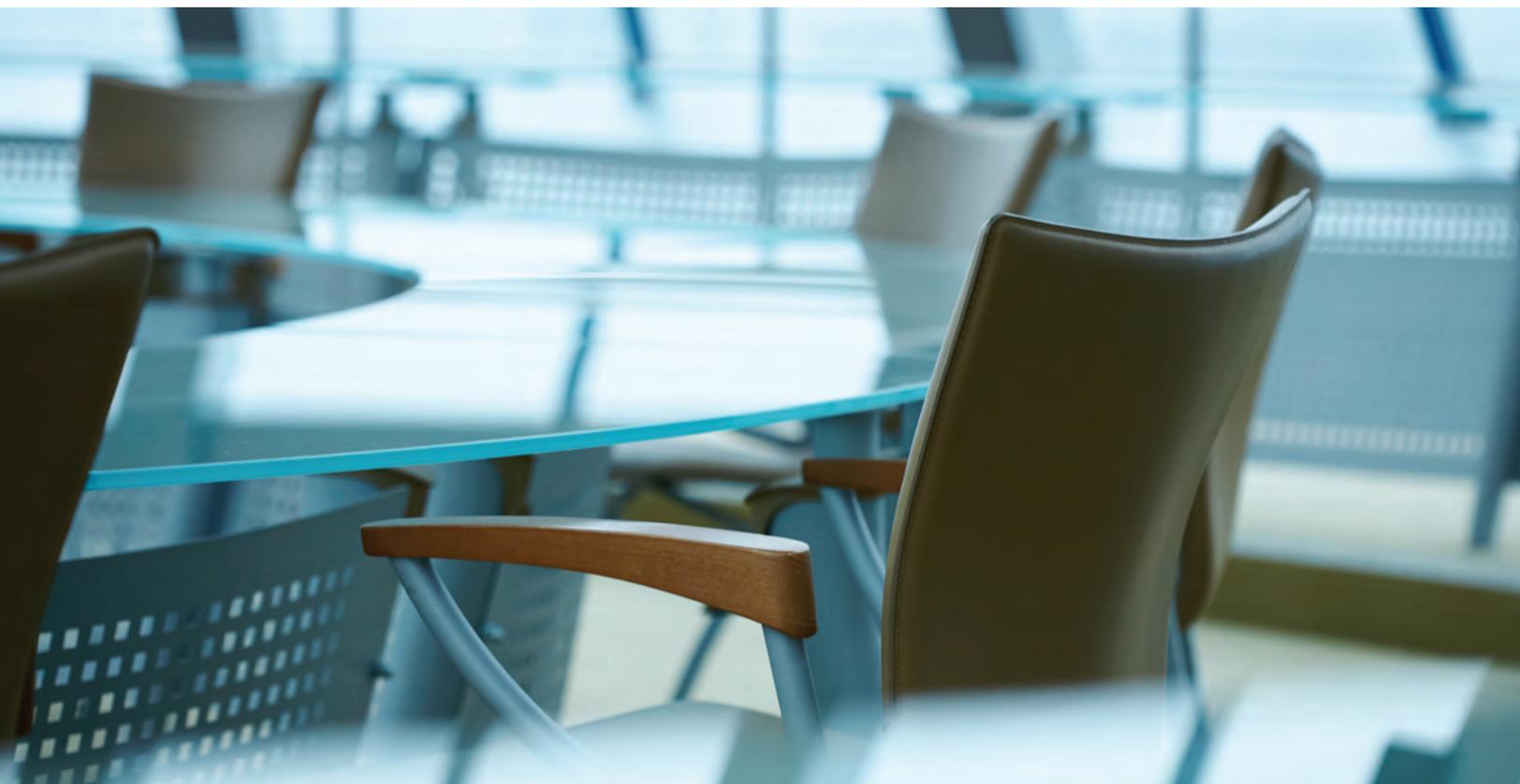
With a claims frequency close to one-in-five (19.4%), it is clear that even the most thorough due diligence process can fail to uncover potential sources of dispute and litigation. With the product being used more often as a deal facilitator, there is a growing understanding of how it can respond to a wide range of issues that arise from transactions. Furthermore, new industry breakdowns by breach types this year show which sectors are more prone to some risks, as opposed to others.

"Our aspiration," says Mary Duffy, global head of M&A insurance at AIG, "is that over time – as we build and refine this claims data – it can be used to help clients and their counsel to negotiate better deals. By better understanding where deals get tripped up, they may be able to refine the way they carry out their due diligence."

At a glance

- Almost one in five AIG R&W policies received a claim notification – up slightly and in line with last year's results.
- The biggest deals have the highest average claims frequency (24%) and the largest average claims (\$19m), and the size of claims on smaller deals is increasing.
- Breaches vary depending on the specific industry, with compliance with laws being most common for Health & Pharma (31%), financial statements for Financial Services (25%) and Manufacturing (17%), and tax for Technology firms (25%)

¹ Usually referred to outside the US as warranty & indemnity insurance (W&I)



The M&A Insurance Market

The value of global mergers and acquisitions fell just short of previous years in 2017, but still exceeded \$3tn for the fourth consecutive year. Market participants expected activity to accelerate in 2018, an expectation that appears to have been confirmed as global deal making approached \$900bn by the end of March 2018 – up 18% compared to Q1 2017, as pressure from investors and a search for innovation drove companies towards M&A.²

While there are incentives in place for buyers to conduct a thorough due diligence process, increased competition for targets together with demands from investors to deploy capital, produce additional pressure on deal timetables. Cross-border deals that involve multiple jurisdictions are also fraught with complexity, particularly in developing markets. This may be a driver of warranty breaches in Europe, Middle East and Africa (EMEA) and Asia Pacific (APAC), which see a lot of cross-border transactions.

In the prolonged sellers' market, there is naturally pressure to execute transactions quickly. R&W insurance is increasingly seen as a facilitator, helping negotiations proceed more smoothly, particularly in seller auctions or when discussions have stalled. "There's a lot of pressure to get the deal done and sometimes issues are not being identified until post-merger," says Dr. Dennis Froneberg, North Europe M&A manager at AIG.

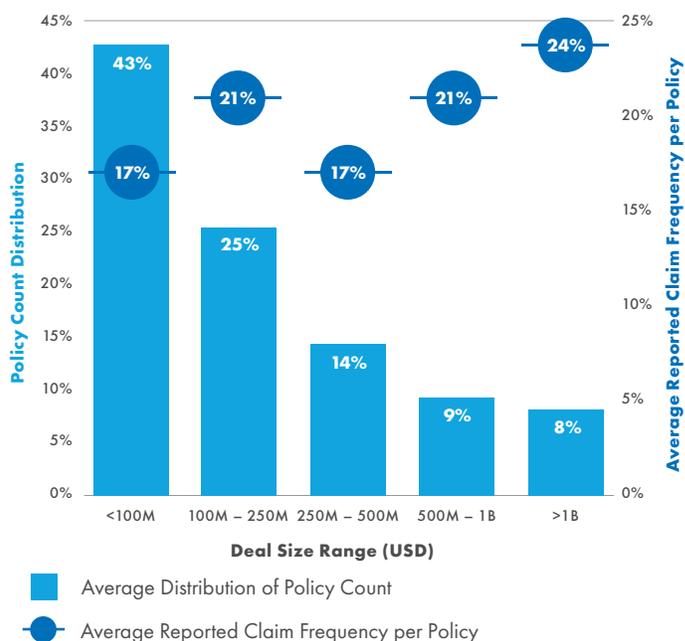
As dealmakers increasingly rely on R&W insurance, the M&A insurance market will be more focused on the sustainability of the product, as well as consistency and predictability in claims handling. This is where considerations such as carrier experience, financial strength and global reach become increasingly important.

The influx of new M&A insurers into this specialist market is softening rates and broadening coverage. Carriers will therefore need to manage this dynamic carefully if the market is to be sustainable in the long term.

Coming of age

R&W insurance continues to reflect elements of both severity³ and frequency, with one in every five policies receiving a claims notification (19.4%). Broken down by deal size, frequency increased year-on-year for the mid-sized and largest deals. "The overall frequency is going up and claims are coming in earlier," observes Duffy.

Fig 1 R&W Reported Claim Frequency by Deal Size



The claims statistics for policy years 2011-2016 show that the largest percentage of claims are made in relation to transactions with a deal size over \$1bn, with 24% of policies written receiving a claim (up from 23% the year before). Frequency has also increased from 18% to 21% for the next largest band of deals (those costing between \$500m and \$1bn).

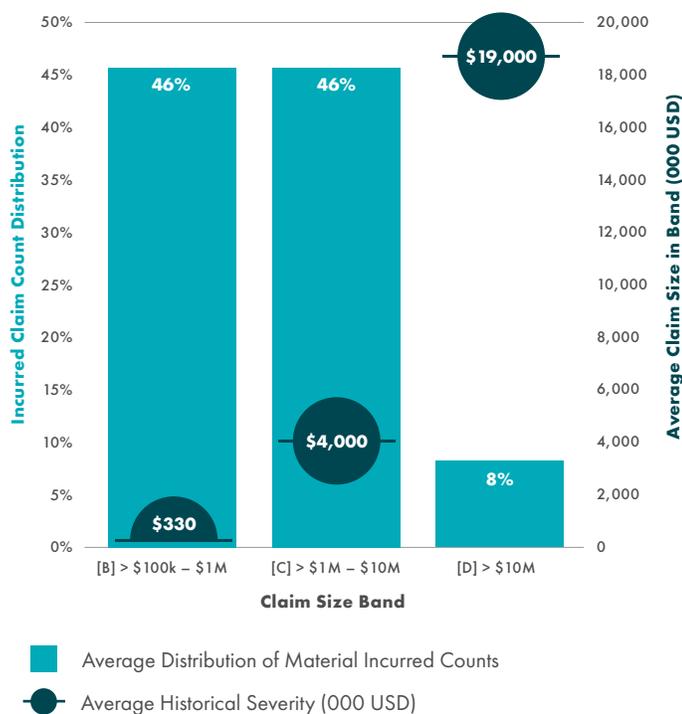
This is both reflective of AIG's book of business and the inherent complexities of large M&A transactions. It is almost impossible to cover every base for deal sizes that exceed \$500m, comments UK M&A manager Angus Marshall.

"More of the AIG portfolio is made up of larger deals. In our experience, for those larger deals, diligence is far more complicated, costly and more difficult for dealmakers to assimilate – these very practical issues do have a material impact on transaction risks" he says. "So the fact that the study reflects higher breach incidents for the bigger deals is what we would expect to see."

² 'Mergermarket Releases 2017 Full Year Global M&A Trend Report.' Mergermarket, 3 Jan 2018 <https://www.mergermarket.com/info/mergermarket-releases-2017-full-year-global-ma-trend-report>; 'Mergermarket Releases Q1 2018 Global M&A Report.' Mergermarket, 4 Apr 2018 <https://www.mergermarket.com/info/mergermarket-releases-q1-2018-global-ma-report>

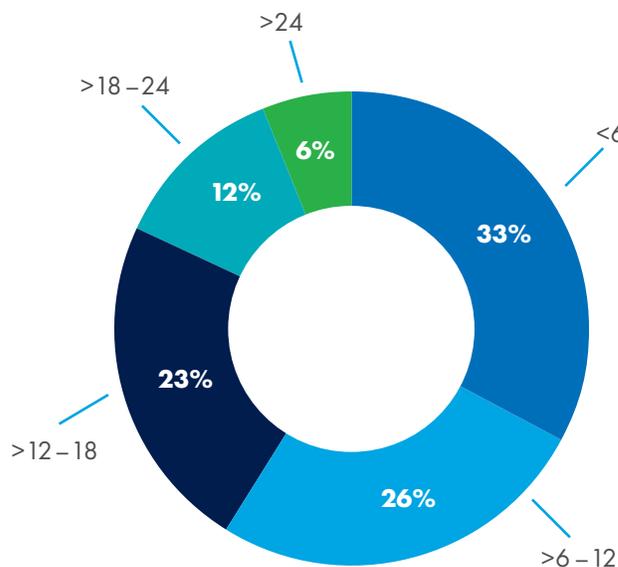
³ Claim severity is the amount of claim payments plus estimated case reserves (i.e. estimated future payments on claims already reported) divided by the number of clients receiving claim payments or are expected to receive claim payments in the future on claims already reported.

Fig 2 **R&W Material Claims – Distribution of Counts and Average Size by Claim Size Band**



Claims are also being made in a more timely fashion. Overall, 33% of claim notifications are made within the first six months after policy inception, up from 27% a year ago. This reflects the expanding knowledge of the scope of the product and how it responds.

Fig 3 **R&W Distribution of Average Claim Report Lags from Policy Inception Date (in Months)**



While severity is down marginally with an average payout of \$19m versus \$22m a year ago for settlements in excess of \$10m, it is clear the largest claims remain very material. If something goes wrong on these deals, a breach of warranties can be extremely costly.

The incidence of claims in the over \$10m category now account for a larger proportion of AIG’s R&W material claims experience at 8% (up from 7% a year ago). And the size of these claims demonstrates the value R&W insurance can provide on large deals, explains Marshall. “A warranty breach on a large deal will often have a multiplied impact on the value of the business – coverage on this basis provides significant comfort to dealmakers that, if something does go wrong, meaningful indemnification is on hand to protect investment value.”

Nearly half of all material claims (46%) received by AIG between 2011-2016 are in the mid-sized distribution (payouts of between \$1m to \$10m) with an average settlement of \$4m, up from \$3.5m a year ago. A similar number fall into the smallest category, which saw the average settlement increase from \$300k to \$330k in the same period.

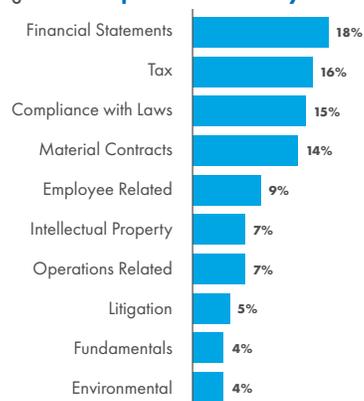
“The claims we’re receiving are generally better presented,” says Duffy. “It is obvious that the clients and their advisers making the claims have a better understanding of what the policy covers and what the insurer will need to see in order to evaluate the claim effectively. So we’re starting to see those first-party loss claims proceed more quickly.”

Michael Turnbull, Americas M&A manager at AIG notes that, in a competitive environment, while there is intense pressure to expedite certain deals, clients understand that R&W insurance is not there as a substitute for diligence. “I don’t know if we’ve seen a lot of difference in diligence trends – I think the increased claims frequency is more a function of how people are treating the policy,” he says.

In the Americas, 45% of claims are submitted after 12 months, which is when the majority of escrow funds are released. However, there is also a trend whereby notifications are coming in earlier in this market than was the case historically. “That’s quite a large difference and probably as a result of people becoming more used to how the product works and seeing that it’s paying out,” says Turnbull.

Behind the breaches

Fig 4 R&W Reported Incidents by Breach Type – GLOBAL TOTAL



Globally, the largest category of breach type is financial statements, but tax remains the biggest driver of reported incidents in EMEA (at 24%), with Germany a significant driving force, according to Dr. Froneberg. "It's no surprise that a large portion of claims in EMEA are related to tax, given how difficult it is to carry out meaningful due diligence in all those different jurisdictions you're operating in across Europe, with no unified tax system," he explains. Further, Dr. Froneberg adds that "there are countries such as Germany where the respective tax authorities are conducting frequent tax audits on corporates, in which case it is very likely that we receive at least one claim notice related to taxes in such countries".

For Southern Europe, a significantly smaller book of business, increased use of the product comes from a rise in the number of insured deals in the real estate sector, according to María José Cruz, AIG's South Europe manager for M&A. She notes demand for the product is steadily growing and that dealmakers are becoming more sophisticated in their understanding of the role of R&W insurance.

Meanwhile in Asia Pacific, financial statements and material contracts are collectively responsible for nearly half of all notifications. Darren Savage, Asia Pacific M&A manager at AIG observes, "The majority of deals in Asia Pacific are multi-jurisdictional in nature and so we tend to see complicated contractual arrangements on those deals. That could explain why material contracts claims are more prevalent."

In the Americas, compliance with laws, financial statements and material contracts remain the main drivers of reported incidents (at 18%, 17% and 14% respectively). Turnbull notes that financial statements and material contracts breaches often go hand-in-hand on claims notifications from insureds.



Drilling down by industry

For the first time AIG has released statistics on breach type by industry sector, indicating which sectors are more prone to some risks than others. “We’re trying to help clients understand where the risk sits,” explains Turnbull.

While the data shows manufacturing companies experience a broad spectrum of breach types, Turnbull is not surprised to see that the most common breach types within manufacturing are financial statements and material contracts. “When you’re manufacturing something, you’re heavily reliant on key customers and suppliers and so your material contracts are going to be a key part of your business,” he explains.

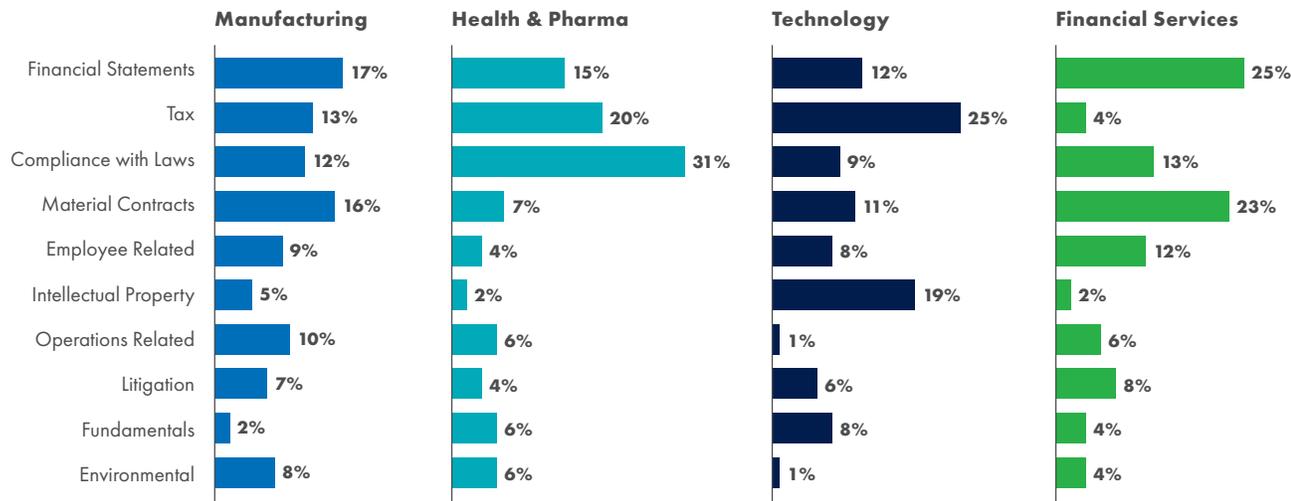
Unsurprisingly, 31% of breach types within the health and pharmaceutical sector relate to compliance with laws, while 19% of breach types within technology deals are in relation to intellectual property. However, the fact that 25% of the reported breaches on technology deals relate to tax may be somewhat unexpected.

This may be a function of the broad geographic reach of many technology companies, implicating a larger number of taxing jurisdictions and increasing the potential for tax liability.

Almost half of the breaches cited on financial services claims relate to either financial statements or material contracts. Compliance with laws comes in at a relatively low 13%, which is perhaps surprising for such a highly regulated industry.

“This additional industry data helps take M&A insurance out of the abstract and into the real world,” explains Duffy. “It shows us that many of the issues that sit at the heart of your business – financial statements, compliance, taxation – are the things that will affect your deal in the most material way,” she adds. “It tells us that M&A insurance is providing meaningful cover, because we’re seeing breaches of warranties that were covered under the policy in respect of those key risks.”

Fig 5 R&W Reported Incidents by Breach Type and Industry



Claims Case Studies

Tax (APAC)

After acquisition, the insured buyer of an Australian company became aware of the underpayment of historic Goods and Services Tax by the target. This issue was not disclosed by the seller prior to entering into the acquisition agreement, which resulted in the insured buyer over-valuing the target company. The insured buyer was able to settle the historic liability as part of the completion statement. However, due to the manner in which the amounts had been treated in the accounts, the underpayment of the tax also had the effect of inflating earnings before interest, taxes, depreciation, and amortisation (EBITDA), a factor included in determining the purchase price for the business.

The insured claimed various breaches of warranties. AIG investigated the circumstances of the claim and was able to verify the claimed breaches. AIG indemnified the insured for loss suffered as a result of over-paying for the target company, because the inflated revenue impacted the price paid for the target.

Compliance with Laws (US)

A corporate buyer purchased an R&W policy for the acquisition of a manufacturing company. After the deal closed, federal inspectors shut down the factory of the acquired company for three days on account of regulatory violations. The buyer was required to outsource production and reconfigure the factory. The buyer believed that the company had not been complying with regulatory requirements for some time, the inspection was the result of a prior ongoing regulatory investigation, and the failure to disclose such issues was a breach of the compliance with laws representation in the acquisition agreement. The buyer submitted a claim under the policy for its direct losses, including outsourcing costs and factory improvement costs, and for an increase to its ongoing operating expenses for compliance with regulatory guidelines. The buyer quantified its loss in accordance with the EBITDA multiple it applied in valuing the target company.

AIG retained financial advisors and a regulatory consultant, who worked with the buyer's management team in understanding the issues that caused the representation breach. AIG confirmed that a breach of the compliance with laws representation had occurred and established that the amount of direct losses suffered by the buyer on a multiplied basis was the correct measure of damage. As a result, AIG paid a significant sum to cover all claimed losses incurred by the insured.



Multiple Breaches (EMEA)

Two years after the acquisition of a pharmaceutical business, a tax audit of the target revealed that the company was not eligible for certain refunds that had been claimed in respect of a tax applied to a key production component. The tax authorities demanded a payment of the relevant tax, together with late payment interest.

The buyers informed the insured sellers and AIG that the relevant circumstances had not been disclosed during the acquisition due diligence process, and so constituted a breach of both tax and compliance with law, licenses and consent warranties. Having evaluated the claim in collaboration with the insured's advisers, AIG was able to confirm coverage in respect of any taxes payable and agreed to cover the legal costs for the proposed appeal of the tax authorities' determination.



Methodology

There were more than 400 claims during the study period – spanning policies covering approximately 2,000 deals, worth more than \$700bn in deal value – though the number of material claims was smaller. Policies written during the study period still hold the potential for a claim.

The period reviewed in this report (policies written by AIG between 2011 and 2016) represents a significantly larger pool of transactions than the period prior to 2011, given the growing use of R&W policies on transactions over the past five years. The results should not be considered conclusive with respect to the broader context of all private mergers and acquisitions, as the percentage of deals insured by R&W policies is still relatively small. Nevertheless, the snapshot of R&W claims activity contained in this report provides interesting insights to buyers, sellers, and M&A advisers.

About AIG's M&A insurance team

AIG has been assisting buyers and sellers with over 3,000 deals insured globally since the late 1990s. The number of deals and the breadth of the portfolio, spanning across geographies, industries, and sectors, uniquely places AIG to share insights into mergers and acquisitions based on observations about the claims made on those policies.

R&W claims can be complex, incorporating difficult issues as diverse as the scope of the warranties insured. When facing a significantly large loss on a transaction, clients do not want their insurance claims handler learning about how a deal works for the first time. AIG has assembled a global network of in-house claims professionals to manage and resolve these types of claim. Made up of experienced professionals located in strategic offices throughout North America, Europe, and Asia Pacific, claims handlers work in partnership with the underwriting team. AIG insureds benefit from dealing with knowledgeable claims handlers who understand the complex nature of R&W claims and can focus on the key issues and bring them to resolution as quickly as possible.

CLAIMS FIRST

Insights & Risk Prevention

www.aig.com

Mary Duffy

Global Head
Mergers & Acquisitions

Tel: +44 (0)20 7954 8104
mary.duffy@aig.com

Darren Savage

APAC Manager
Mergers & Acquisitions

Tel: +61 3 9522 4975
darren.savage@aig.com

María José Cruz

South Europe Manager
Mergers & Acquisitions

Tel: +34 915677 452
mariajose.cruz@aig.com

Michael Turnbull

Americas Manager
Mergers & Acquisitions

Tel: +1 212 458 6203
michael.turnbull@aig.com

Dr. Dennis Froneberg

North Europe Manager
Mergers & Acquisitions

Tel: +49 (0) 69 97113-330
dennis.froneberg@aig.com

Angus Marshall

UK Manager
Mergers & Acquisitions

Tel: +44 (0)20 3217 1614
angus.marshall@aig.com



The scenarios described herein are offered only as examples. Coverage depends on the actual facts of each case and the terms, conditions and exclusions of each individual policy. Anyone interested in the above product(s) should request a copy of the policy itself for a description of the scope and limitations of coverage.

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