MARSH

2020 US AND CANADA TRANSACTIONAL RISK YEAR IN REVIEW | MARCH 2021

Despite Pandemic, US and Canada M&A Players See Value in Insurance

MARSH & McLENNAN COMPANIES

MARSH'S US AND CANADA TRANSACTIONAL RISK INSURANCE PRACTICE: 2020 AT A GLANCE

Closed transactions up **+11%**

Policies placed up **+24%**

$19.6B in total limits placed

Claim notices **+100%**

Average transaction size: **$345M**

Median transaction size: **$130M**

Total insurer capacity: **$1B+** for any single transaction

The world continues to grapple with COVID-19 and its myriad effects on people and businesses. The pandemic's economic impacts have been widespread, including contributing to tumult in the M&A market — and the transactional risk insurance market.

After some early momentum, M&A activity came to a screeching halt in the second quarter of 2020. But the second half was a different story, with deal volume soaring to record heights.

The transactional risk insurance market experienced similar swings in 2020. A strong start gave way to a deep lull in activity. Signs of a recovery, however, were seen in the third quarter, followed by explosive growth in the fourth quarter. All told, Marsh's US and Canada Transactional Risk Insurance Practice successfully completed 584 insurance placements on mergers and acquisitions in 2020 — an 11% increase from 2019.

This report looks back at the transactional risk insurance market in 2020 and explores the challenges that are expected in the year ahead, including a continued increase in claims frequency and severity, rising prices, and a focus by insurers on pandemic-related exclusions.

US and Canada Transactional Risk Insurance Market Reaches Record Highs

2020 was a year of highs and lows for M&A, including in the US. Overall US M&A activity ended 2020 down 21% by value and 16% by deal count from 2019, according to data from Mergermarket (see Figure 1). But those overall figures do not fully reflect the volatility seen in the past year.

While the first quarter saw modest activity, deals announced in the second quarter totaled just $77.3 billion — a fraction of the $518.3 billion in the second quarter of 2019 and the lowest since the first quarter of 2003. The second half, however, more than made up for the ground lost early in the pandemic: After 2,474 deals worth $296 billion were announced in the first half, the third and fourth quarters yielded a total of 2,709 US deals worth $961.4 billion. That includes $545 billion in deal value in the fourth quarter — the highest on record, according to Mergermarket.

FIGURE 1

Overall US deal volume fell 21% in 2020, but reached a record high in the fourth quarter.

SOURCE: MERGERMARKET

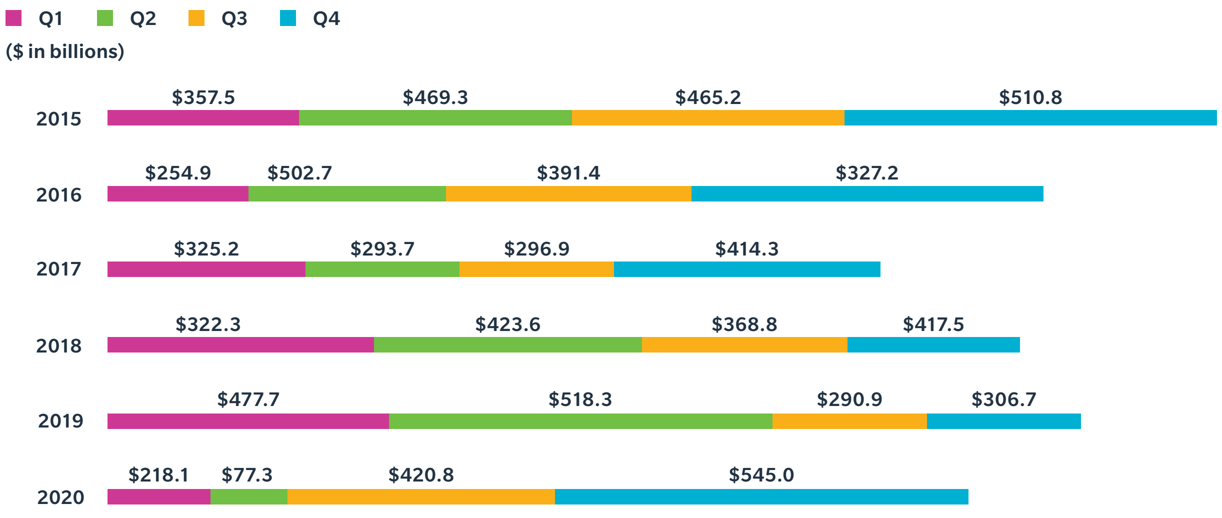
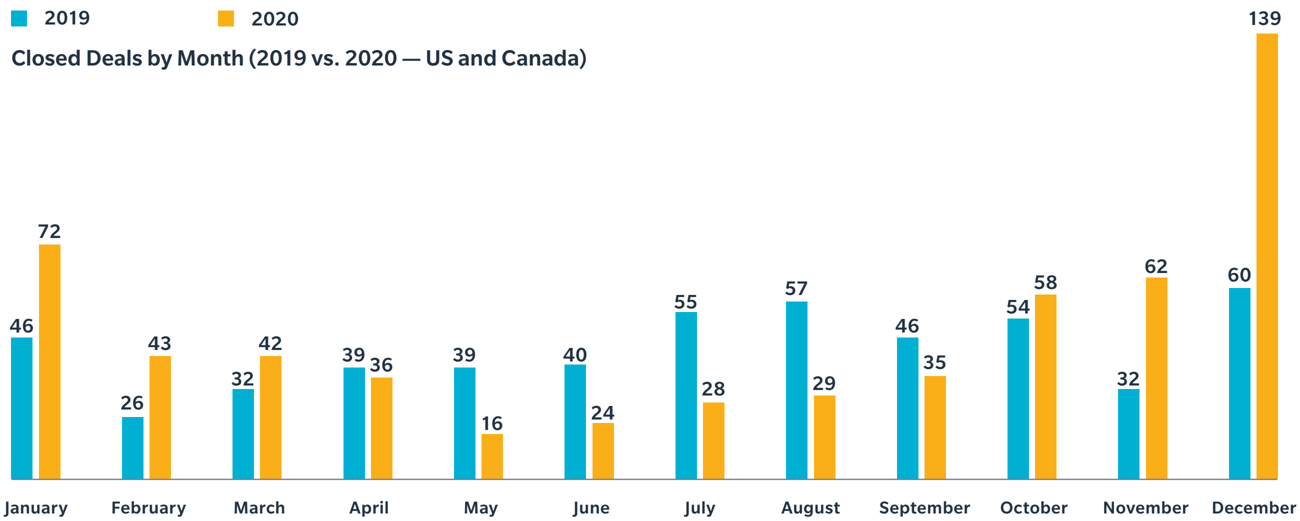


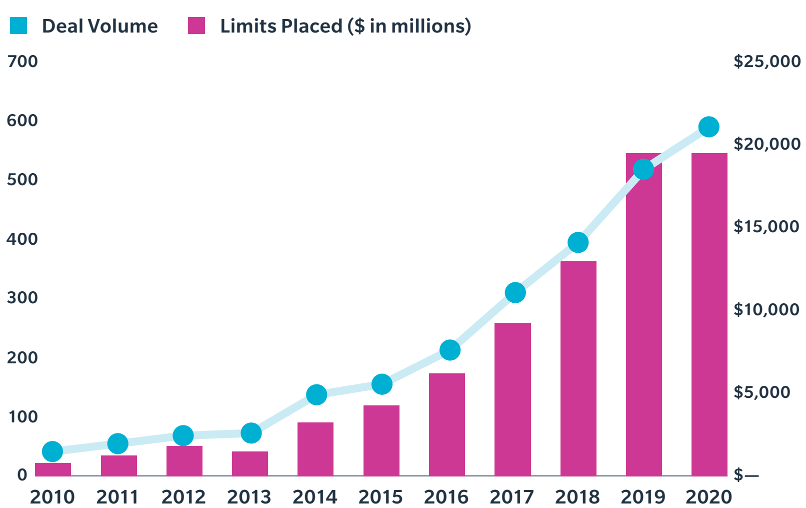
FIGURE
2

A tumultuous 2020 was capped off by record activity in Q4 for Marsh's US and Canada Transactional Risk Insurance team.

SOURCE: MARSH



The transactional risk insurance market charted a similar course in 2020 (see Figure 2). After what started off as a promising year — with Marsh closing what was then a record 157 transactional risk placements in the US and Canada in the first quarter — deal volume was cut in half in the second quarter. But like the overall M&A market, transactional risk activity recovered significantly. Our team closed 92 deals in the third quarter and 259 in the fourth quarter — a new record for Marsh and a 77% increase from the fourth quarter of 2019.



Despite the headwinds of COVID-19 and other trends contributing to an overall decline in M&A activity in 2020, Marsh's transactional risk insurance placements increased to 584 closed transactions, up 11% from the 526 transactions we closed in 2019 and a continuation of the market's long-term growth (see Figure 3). We also placed 1,041 primary and excess policies — the first time our team has placed more than 1,000 transactional risk policies in a calendar year and a 22% increase over 2019. It was also the second straight year that limits we placed on behalf of our clients totaled nearly $20 billion.

These results are evidence of the growing value that key M&A players see in transactional risk insurance, and a sign of its enduring role in the deal-making environment in the US and Canada.

Insurers Remain Committed to Transactional Risk

In 2020, the marketplace for transactional risk insurance remained robust in the US and Canada, in spite of the many challenges presented by the pandemic. Insurers continued to show their commitment to the sector, with new entrants — including DUAL and Hamilton — setting up shop and existing insurers deploying capital without interruption. Total insurer capacity exceeds $1 billion in limits for any single transaction and nearly 25 insurers are presently offering terms on a primary basis.

For Marsh, median transaction size held steady at $130 million. Average transaction size increased slightly, from $344 million in 2019 to $345 million in 2020.

Private equity firms continued to represent the majority of insureds in programs placed by Marsh — purchasing approximately 53% of all policies. Still, the trend of corporate and strategic buyers increasing their usage of transactional risk insurance continued in 2020, and we expect 2021 to bring more of the same.

Transactional risk insurance continues to be used by deal participants across a number of industries. Undaunted by the pandemic, the leading industry in 2020 by deal volume in the US was technology at $346.5 billion, according to Mergermarket. It's thus no surprise that communications, media, and technology were involved in more transactional risk placements than any other industry, accounting for more than a quarter of all deals completed by Marsh in the US and Canada (see Figure 4).

Downward Pricing Trend Interrupted

From 2015 to 2019, rates for representations and warranties (R&W) insurance steadily declined. That trend, however, was halted in 2020.

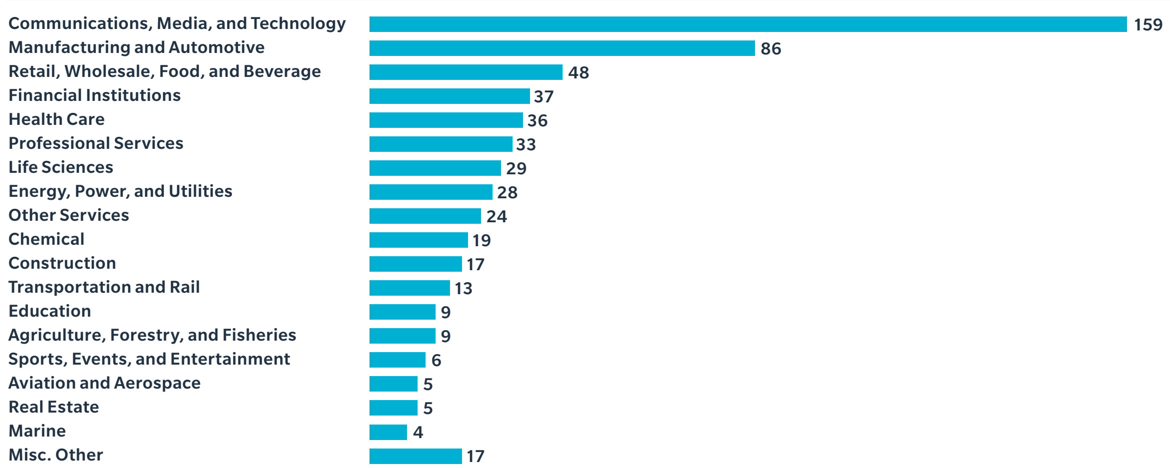
Primary R&W insurance rates increased across the Marsh portfolio by 9.7%, to 3.04% rate on line, which is calculated by dividing premium by policy limits (see Figure 5). 2020 marks the first year of primary rates sitting above 3% since 2017, which we attribute principally to two factors: an increase in the frequency and severity of transactional risk claims and "surge pricing" during the flood of deal activity in the fourth quarter.

While the pricing surge has to some degree abated in the first quarter of 2021, claims concerns continue to influence insurers' approaches to pricing. In light of the continued uptick in claims activity, we expect rate increases to continue in the short- to medium-term, although the presence of recent market entrants could help to offset pricing pressure to some extent.

FIGURE 4

Communications, media, and technology companies led all industries in transactional risk insurance placements in 2020.

SOURCE: MARSH



Pandemic Driving Policy Exclusions

It is difficult to overstate the impact COVID-19 had on the transactional risk insurance marketplace in 2020. After the onset of the pandemic in March, M&A activity came to a near standstill in the second quarter, with a corresponding slowdown in the transactional risk insurance sector.

For those transactions that progressed forward in the second quarter, insurers imposed broad COVID-19 exclusions in their R&W policies as they digested the impact of the pandemic on the overall economy and their own bottom lines. As M&A participants adapted to pandemic deal-making later in the year, insurers tended to narrow their focus of COVID-19 (and accompanying exclusions) to the distinct impacts of the pandemic on each target company.

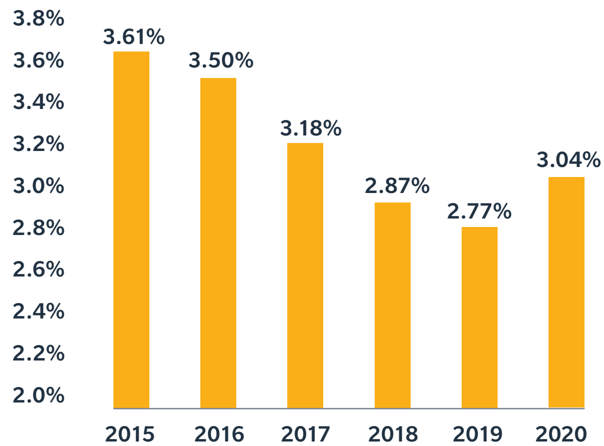
As the virus surged late in the fourth quarter, broader COVID-19 exclusions returned, but at the start of 2021 insurers are generally back to underwriting COVID-19 risk on an individualized basis. We anticipate that COVID-19 exclusions (in some form) will remain in R&W policies throughout the remainder of 2021.

FIGURE 5

R&W insurance pricing increased by almost 10% in 2020 after falling for four straight years.

SOURCE: MARSH

Primary Layer R&W Insurance Pricing — 2015 to 2020



Other Notable 2020 Trends

No seller indemnity structures: A long-term trend that persisted in 2020 is an increase in the number of transactions that feature no seller indemnity, meaning that the seller does not have any contractual liability to buyer for breaches of representations and warranties, other than fraud. This structure — also known as a "public-style" deal — historically represented a small fraction of the overall private company transaction universe and was typically reserved for only very large transactions (typically $1 billion or more of enterprise value). But it has become far more prevalent in recent years, driven by usage in smaller transactions — even some valued at less than $100 million. In 2020, almost half (49%) of the transactions in Marsh's transactional risk portfolio featured no seller indemnity structures, up from less than 25% in 2015. We anticipate that this trend will continue in the short- to medium-term.

Deductibles: Deductibles held steady at approximately 1% of enterprise value for most transactions in the middle market, with a dropdown feature to 0.5% of enterprise value at the 12-month anniversary of closing. On larger transactions — those with enterprise values of $400 million or more — it is common for the deductible to be 0.75% of enterprise value, or possibly even lower on transactions with an enterprise value in excess of $2 billion, with the same dropdown feature.

Transaction size vs. limits purchased: The average and median enterprise value per insured transaction in the US and Canada was consistent with the prior year, at $345 million and $130 million, respectively. Average policy limits — as a percentage of enterprise value — also remained steady across Marsh's portfolio, at just over 10%.

There were, however, sharp divergences in the relative amount of limits purchased depending on the size of the deal. For smaller deals — below $50 million in enterprise value — buyers purchased limits on average equal to 18.7% of enterprise value. In midsize deals — $100 million to $250 million — buyers purchased coverage limits on average equal to 10.9% of enterprise value. In large deals — $2 billion or more — buyers purchased limits on average equal to 6.1% of enterprise value.

In 2019, corporate insureds purchased more limits than private equity insureds on similarly sized deals. This trend continued in 2020 and is expected to persist in 2021.

Tax insurance: Demand for tax insurance remained solid throughout 2020. While aggregate tax insurance limits and the number of tax insurance policies placed by Marsh were on par with 2019, the range of matters covered by tax insurance expanded significantly.

In 2019, the majority of tax insurance limits were placed in the renewable energy sector, ahead of the planned expiration of investment and production tax credits for industry participants. Congress, however, passed legislation to extend the tax credits, while the Treasury department enacted pandemic-driven updates to safe-harbor guidance, which has provided renewable energy developers additional runway. Accordingly, tax insurance limits bound in 2020 were more concentrated to placements in connection with M&A. Tax insurance was also increasingly used to effect non-transactional balance sheet risk management.

Total policy limits and the number of completed tax deals were fairly flat year-over-year, but the number of policies bound increased substantially, a sign of what might be in store in 2021. As additional underwriters continued to enter the market, average premium rates in 2020 fell slightly, which — coupled with added flexibility of policy terms — signals that tax insurance may strengthen its foothold as a cost-effective risk management tool going forward.

Claims: The number of claim notices submitted to R&W insurers from Marsh clients more than doubled in 2020, and that pace is expected to steadily increase as the volume of R&W transactions closed each year continues to grow. There has also been a corresponding increase in claims payments made to insureds: In 2020, R&W insurers paid claims to Marsh clients in amounts ranging from approximately $150,000 to $20 million.

Claims handling by R&W insurers remains a key factor in the selection of an insurer at the outset of the underwriting process, with deal participants increasingly focusing on selecting insurer counterparties with reputations for smooth and efficient claims processes. As claims frequency ramps up, it's also vital for transactional risk insurance buyers to understand how the claims process works and the roles they and their brokers can play in expediting their resolution.

Managing Transactional Risk in 2021

The events of 2020 confirmed the role that transactional risk insurance continues to play in the M&A marketplace. Amid a pandemic that substantially depressed US M&A activity, Marsh placed more transactional risk insurance policies than ever. The expanded use of transactional risk solutions by smaller enterprises and for the largest deals consummated in the US alike reflects the essential role they can play in deal processes.

At the same time, increases in claims frequency and severity are expected to continue in 2021 and beyond, as are corresponding rate increases for transactional risk insurance products. That means it's more important than ever for businesses involved in mergers and acquisitions to carefully consider their risks and work with the right risk advisors.

Specifically, those involved in mergers and acquisitions should seek to work with risk advisors that can offer:

- **Dedicated transactional risk expertise.** Advisors with experience working on M&A deals can help identify potential challenges during the deal process for which insurance and other strategies can offer solutions. They can also help you build insurance programs with terms and conditions aligned to your specific risks.
- **Market knowledge, relationships, and insights.** Not every insurer is the same, and it's important to select the right one given the nature of your unique transaction. The right advisor can help you understand the risk appetites, preferences, and capabilities of various insurers and help guide you through the underwriting process.
- **Robust data and analytics.** Along with your broker's experience in working on previous transactions, peer benchmarking and other analytical tools can inform critical decisions about how to structure insurance programs, including selecting appropriate coverage limits.
- **Claims experience.** Advisors with a history of working on complex transactional risk claims are uniquely positioned to provide guidance in the event things turn contentious with your insurer following a loss.

About Marsh Transactional Risk

The US and Canada Transactional Risk Practice at Marsh is comprised of 30 dedicated insurance professionals whose sole focus is R&W insurance, tax insurance, and other M&A-related insurance products. The team consists of former M&A lawyers, bankers, and seasoned risk management professionals who pride themselves on providing best-in-class service and advice to clients and their advisors on the most complex M&A transactions, often under significant time pressure.

For more information, contact your Marsh representative or:

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