MERGERS AND ACQUISITIONS

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Observers: COVID-19 Investors Stoke Unprecedented M&A Market, Driving Significant Transaction Insurance Take-up

- By Frank Klimko
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WASHINGTON //BestWire// - Rather than drive fear into the hearts of those in the investment community, COVID-19 has fueled an unprecedented mergers and acquisitions insurance market, according to industry observers. One expert said the pandemic's impact is nothing like anything he's seen before in the world of finance.

The accelerating series of deals is also driving a significant take-up of M&A or transactional risk insurance, largely on the demands of sellers who control most aspects of the pandemic marketplace, said Eric Ziff, partner and co-practice leader on Lockton's transaction liability team.

M&A insurance, or transactional risk insurance, is a set of protections designed to help both buyers and sellers mitigate risk and facilitate the closing of a deal. For instance, buyers and sellers are often concerned about how contractual guarantees, taxes, or ongoing litigation might impact a merger or acquisition, according to broker Hub International.

"I've been in the world of M&A for 12 years and I've never seen anything like this. There have been things that have shocked the industry and shocked deal making, but probably not in the way that this did," Ziff said. "Not anything quite like COVID has.

"It's not people doing this because COVID made the world riskier and therefore they want insurance. It's a function of the seller's market," Ziff said.

The uptake in M&A insurance bloomed in the fourth quarter last year, growing by 25%, to 2,374 policies taken out, compared with the same period for the previous year, according to a recent report by the BMS Group. For the first quarter of this year, the report noted a 21% increase of 1,956 policies issued.

"In this very seller-friendly market — valuations are almost back pre-pandemic — buyers are looking at every way they can enhance their proposition to sellers and M&A

insurance is a key way to do that," said Jason Stone, managing director, private equity and M&A, BMS Canada Risk Services Ltd.

It is not because deals are suddenly more dicey.

"The rise in the usage of M&A insurance is simply because deal professionals know more about it and are seeing claims being paid," he said. "Five years ago, many were skeptical if claims would be paid out and now they are seeing significant pay outs by the insurance carriers.

"People quite quickly figured out how to get deals done in an environment that was atypical of how they had traditionally done them before," Stone said. "This frothy deal environment included M&A insurance and pushed the utilization of the product."

One aspect of risk control is the due diligence employed by the insureds during the deal, said Sridhar Manyem, AM Best director of industry research and analytics.

"During this stage, buyers will go through the financials, accounting, size up the management and culture, look at systems, examine any known legal issues to make sure things don't blow up after the deal. But insurance is really for the unexpected," Manyem said.

"To the extent that insureds want peace of mind despite their due diligence M&A insurance is very important," Manyem said. "The latent liability is going to be a little bit more to the extent (that) there could be issues uncovered long after the deal is done."

Another contributing factor in the increase of M&A insurance is that the size and breadth of the deal making generally outstrips the reach of pre-deal due diligence, said Matthew Studley, vice president of financial services for Hub International. M&A cover only kicks in after a deal is closed and has a tail of three to six years.

"There are some very smart people looking at these deals," Studley said. "Depending on the size of the deal, it is absolutely necessary in order to protect potentially both buyer and seller from the risk they don't want to retain.

"It's just not practical to overturn every single stone that exists when reviewing an operating business," Studley said. "There's not enough time and frankly not enough resources that people would be prepared to deploy in order to do that.

The due diligence examinations attempt to be super thorough, Studley said, but there are limits.

"There is always an inherent amount of risk that remains unknown. Even on the known topics where there could be issues, how much diligence are you prepared to pay for when you don't have a deal yet," Studley said.

“The pandemic introduced some financial distress into businesses even if it was short-lived and some of the strategic buyers of businesses may want to take advantage of those situations,” Studley said. “You have a situation where people may be more willing to buy up those businesses coming out of the pandemic.”

M&A cover is almost an expected element of the deal now, said Greylen Erlacher, a principal at Vanbridge, an EPIC company.

“There was a lot of dry powder that wasn’t able to be used last year,” she said. “People are rushing to deploy it now. There are also talks of (future) tax changes so people may want to offload their businesses a couple of years faster than what they were planning on.”

But every M&A deal is different. Much like how Leo Tolstoy, in his 1877 novel “Anna Karenina,” said: “All happy families are alike; each unhappy family is unhappy in its own way.”

“I don’t think there is any secret sauce that works for every deal. There is no quote-unquote normal easy deal anymore,” Erlacher said. “They are unique and all have some unique issues or attribute to them. You never have two deals that look exactly alike.”

Surprisingly, the pandemic has also impacted the increase in deal making because it has changed the way businesses do business. The work-from-home, digital, no-contact environment has carried over into the new normal, said John Marchisi, national director, special purpose acquisition company segment within the financial institutions practice of Gallagher.

“What’s been most interesting is the COVID situation has contributed to a proliferation of these deals in a way that most people don’t realize,” he said. “It’s from the virtual Zoom meeting environment. People who have created tremendous amounts of efficiency in deal making and in having meetings.

“For example, one of my clients is going through a combination currently and have held over 200 meetings in an eight-week time frame. That otherwise would not be possible prior to the Zoom environment if they actually had to do that in person.”

Up until a few years ago, buyers still vested roughly 10% of proceeds in escrow, said Kirk Sanderson, managing partner, M&A Insurance Solutions. A $100 million transaction would mean that $10 million would be expected to be put in escrow.

M&A insurance developed into a less-expensive alternative, he said.

“Hey, instead of putting aside your escrow, let’s just replace that with insurance at a significantly lower cost. The private equity firms are the ones that really adopted this,” he said. “They don’t want to be setting aside $10 million (and) $300,000 to $400,000 is much cheaper to them than having $10 million sit in a bank account earning 1% interest for two to three years."

Deal makers consider M&A cover a superior product.

"This is actually not just as good as having indemnification, this is better," Sanderson said. "You have rated insurers that have established records of paying out claims. And the pricing is significantly less."

In general, M&A cover won't be triggered regularly, he said.

"If you have a deal that goes south, it's going to be significant," Sanderson said. "The frequency is low, the severity is typically low. But that doesn't mean that the fear of a high severity event is not possible.

"The impact of something that was incorrect that could be a 10% of enterprise value loss. Who wants to take on that risk? Well a buyer doesn't and a seller doesn't either. Transfer that to a third party," Sanderson said.

Although the M&A products themselves may be complicated, the strategy to use them is simple, said Ziff, of Lockton.

"At their core, they are side-letter indemnity arrangements between a buyer and a credit worthy counterparty which in our case happens to be an insurer. I'm surprised by how quickly people adapted to what was going on and figured out a formula to start doing deals again. Last March, things ground to a halt. By August (2020), we were incredibly busy and we have not stopped since then. Right now this is the busiest I've ever seen the M&A market," he said.

The future of insurance industry megadeals was clouded by the recent termination of the $30 billion merger between brokers Aon plc and Willis Towers Watson plc after objections from the U.S. Department of Justice on antitrust concerns over broking competition. The new Washington D.C. regulatory environment could constrain new deals, observers said (BestWire, July 26, 2021).

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