DELANCEY STREET PARTNERS, LLC

M&A Best Practices Whitepaper Series

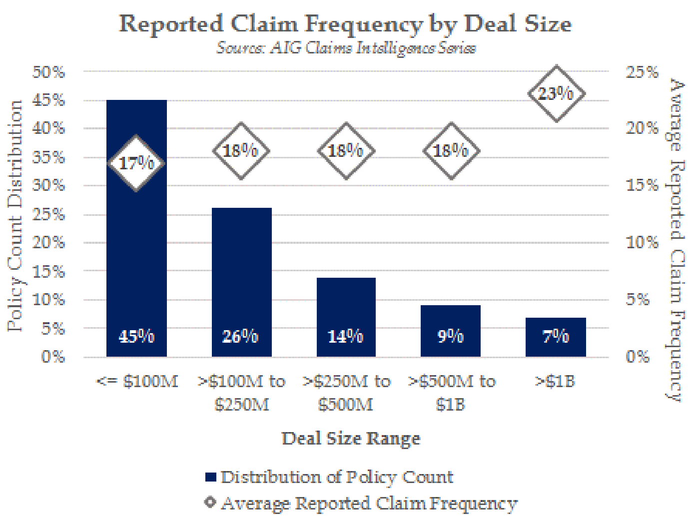
Representations & Warranties Insurance

The Delancey Street Partners M&A Best Practices Whitepaper Series provides insight into key topics that are highly relevant in today's M&A market. From real-time market trends to exit planning initiatives, we explore ideas and concepts that can have a material impact on value and likelihood of a successful outcome in today's dynamic M&A environment.

This installment of our M&A Best Practices Whitepaper Series focuses on representations & warranties ("Reps & Warranties") insurance and its increasingly prominent role in M&A transactions in the U.S. As the market for Reps & Warranties insurance has become more robust and mature, we see its potential use as an elegant solution for handling the indemnification provisions in a transaction, often to the benefit of both buyer and seller.

What is Reps and Warranties Insurance?

An M&A transaction purchase or merger agreement will typically contain certain Reps & Warranties made by the seller about the business being sold, as well as an allocation of the exposure between buyer and seller for unknown risks and liabilities related to a breach of the Reps & Warranties. A breach discovered after the transaction closes can result in the seller returning a portion of the purchase price, or the buyer absorbing an unforeseen cost. As a result, the allocation of risk can be one of the most contentious points of negotiation in a transaction.



Insurance carriers can often provide a Reps & Warranties policy that, in exchange for a premium paid at closing, shifts a portion of the potential liability for breaches of transaction Reps & Warranties away from the seller to the carrier. Such a policy can either serve as an extension of the indemnification terms of the transaction agreement, or may replace the indemnification terms entirely and become the buyer's sole source of recovery. The insurance solution can provide a way to enhance transaction value, but can also serve the role of closing a negotiation gap and salvaging a transaction.

Reps & Warranties insurance has been used commonly in European M&A for many years but, until recently, had not enjoyed wide adoption in the U.S. The market has now matured significantly for middle market transactions in the U.S., and there has been a steady increase in the number of policies underwritten annually as well as a demonstrated track record of claims being paid. In fact, Aon Transaction Solutions indicates that the volume of policies written annually more than tripled from 2013 to 2016. The majority of policies are for transactions below $100 million in size, as shown in the above graphic. On the following pages, we explore the Reps & Warranties insurance product, including its typical application from the standpoint of both buyer and seller.

About Delancey Street Partners

Delancey Street Partners is an independent, industry-focused investment bank. We serve CEOs, Entrepreneurs, Shareholders and Boards of Directors of high growth and middle market private and public companies. Our services include strategic advisory, capital raising and independent board advice. We advise on sell-side and buy-side M&A, growth capital financings and recapitalizations. Our focus sectors include Business Services & Technology, Healthcare, Industrial & Industrial Technology, and Infrastructure.

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"Buy-Side" vs. "Sell-Side" Policies

Reps & Warranties insurance policies are available for both buyers (a "buy-side" policy) and sellers (a "sell-side" policy), and while the appeal of the policy and the strategy for using it may differ between them, each functions as a way to shift potential liability to an insurer.

Buy-Side Policy Considerations

A buy-side policy insures the buyer and offers alternative or additional protection relative to the negotiated indemnification terms in a purchase or merger agreement. Buy-side policies can provide a way for a bidder to distinguish itself from other parties that require escrows or purchase price holdbacks, higher liability caps, and longer survival periods. Due to these strategic advantages (and the value to buyers in controlling the claims process), the vast majority of policies are placed in the name of the buyer. Several attractive features of a buy-side policies can include:

- Potentially reduce or eliminate escrow or purchase price holdbacks for indemnity claims, thereby generating a higher proportion of proceeds at closing for the seller – this can be particularly appealing to a private equity seller that seeks to return capital to investors
- Provides a creditworthy party standing behind claims and protects against insolvency or collectability risk related to the seller (e.g., a foreign seller or multiple sellers)
- For cases in which sellers include management that will remain with the company, provides an alternative source of recourse that can preserve future relationships
- Since the buyer will look to insurance for claims (rather than, or in extension of, seller indemnity), the seller may be more accommodating in negotiating a purchase or merger agreement

Sell-Side Policy Considerations

A sell-side Reps & Warranties policy is obtained to insure the seller, providing a backstop to the seller indemnity terms agreed to in a purchase or merger agreement. A sell-side policy is a suitable solution for transactions in which a buyer insists on looking to the seller for indemnity and does not accept a buy-side policy. The development of the Reps & Warranties insurance market in the U.S. provides insurance products that can improve seller outcomes in many different scenarios. Sell-side policies offer a number of compelling features, including:

- For private equity sellers nearing the end of a fund's life, a sell-side policy can limit the post-closing exposure of a particular transaction and enable the fund to return capital to its investors
- For any seller, a sell-side policy can substantially increase the likelihood of recovering escrows of purchase price holdbacks, as the insurer provides a backstop to seller indemnity in excess of the policy deductible
- In a transaction with multiple sellers, Reps & Warranties insurance can limit the exposure of minority sellers for joint and several liability with regard to indemnification claims

Pricing Observations

The cost of a Reps & Warranties policy is determined by a number of factors, including the nature of the target's business (which can impact the risk profile to the insurer), the industry in which the company operates and the size of the policy limit and retention (deductible) level. And while the market can provide solutions for a variety of transaction size, minimum premium and retention levels can make policies for smaller transactions relatively more expensive as a percentage of policy limit. In today's market, a price range of 2.5-4.0% of policy limit is common, inclusive of premium, as well as diligence, underwriting and other related fees.

Who Pays?

Thorough M&A process planning includes exploring the availability and pricing of Reps & Warranties insurance well before a dialogue on the topic with potential bidders. Stipulating a seller-favorable indemnification package along with the expectation that buyers obtain insurance coverage at their cost sets a clear expectation in final proposals and enables aggressive bidders to distinguish themselves from others by understanding and accepting the seller's terms. Who bears the ultimate cost of the premium and related expenses is negotiated as part of the term sheet, but careful planning and setting seller expectations in a competitive process improves the likelihood of a favorable outcome for the seller.

Case Study: Buy-Side Policy in a $100 million Transaction

As an example of how Reps & Warranties insurance can work in a transaction, consider this illustration. In this example the target company is a privately-held business with a purchase price of $100 million.

Scenario A

- A process is run, but the concept of Reps & Warranties insurance is not introduced
- All bidders propose traditional indemnification packages that include "market level" indemnification caps, escrows and survival periods
- The final transaction includes a cap and escrow of 10% of the purchase price, and an 18-month survival period
- The seller receives $90 million at closing, but has $10 million at risk for 18 months

Scenario B

- In a competitive process, the seller includes a Reps & Warranties insurance proposal with the bid instructions
- The seller proposes that the bidders absorb the policy costs, but offers a 1% escrow to cover a portion of the retention
- Winning bidder accepts the insurance proposal and obtains a Reps & Warranties policy with a $10 million limit, at the buyer's cost
- The seller receives $99 million at closing, with only the $1 million retention escrow at risk for the 18-month survival period

Final Thoughts

Reps & Warranties insurance, along with the broader suite of transaction solutions, is quickly becoming a standard feature of many deals and is transforming how M&A professionals think about allocating risk. Buyers, sellers and their advisors now readily recognize the strategic value in using insurance as an alternative to traditional indemnification structures, allowing sellers cleaner exits and buyers the robust protection they seek. Aon Transaction Solutions in North America alone placed R&W insurance for more than 300 deals last year representing over $10 billion in limits, and estimates more than 1,000 policies were underwritten in the U.S. in 2016 industry-wide. Growing trends in the space include increased acceptance and utilization by corporate/strategic acquirers, and sellers positioning deals early on for the use of insurance as an alternative to escrows and indemnities. The increase in demand has also spurred an expansion in the number of insurers in this space, with more than 20 actively underwriting R&W insurance – this highly competitive market has created a favorable environment for insurance buyers with declining premiums and expanding insurer appetite, including for deals at the lower end of the middle market.

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has been acquired by
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has completed a majority recapitalization and growth equity financing with
PeakEquity Partners
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