Secondaries Investor

By: Guest writer
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DEALS

W&I insurance: why it has a role to play in secondaries

The rise of GP-led deals has highlighted the importance of liability protection, bringing warranty & indemnity insurance into the secondary market, say insurance broker Lockton and law firm Akin Gump

Q What is warranty and indemnity insurance and how is it typically employed?

Warranty and indemnity insurance has been around for more than a decade but its use and the breadth of its coverage has increased greatly since 2014. The product shifts all or part of the seller's liability in an M&A transaction to an insurance product. Sellers have used it to reduce their deal liability exposure while buyers have typically used it to increase their protection on a deal. The product is now a mainstream part of the private M&A world with over 40 percent of private equity deals estimated to use it.

Q When did you first start seeing it being used on secondaries deals and how common is it?

The use of insurance in secondaries transactions is not entirely new. However, it has only become more commonplace in the last couple of years (particularly in the context of GP-led transactions) as the universe of insurers providing the necessary cover expands, and investors find novel, strategic ways to leverage the product.

Q Can you give three examples of where it can be employed in secondaries?

Favourable positioning in an auction

With the secondaries market becoming increasingly competitive, investors are looking to the insurance market to insure the fundamental, financial and, if applicable, business warranties offered by sellers. This allows entry into a secondaries auction with a cap on the seller's liability set to a very low level or even nil. This tactic can give a real advantage to a bidder, particularly where a "clean break" is key to the seller (eg, because it intends to wind up after the transaction). However, crucially, it does rely on the vendor due diligence being sufficiently detailed for insurers to gain comfort to offer an insurance product through a typical underwriting process.

GP-led secondaries

For incoming investors in a GP-led context, deal viability will often rest on the performance of a few (or even a single) underlying cornerstone assets where added protection through a W&I policy may well be desirable. This also provides comfort to an investor in a transaction where, when all is said and done, the GP is on both sides of the trade.

Insurers are increasingly open to providing this protection taking into account:

- the due diligence provided by the seller;
- a combination of any focused buyside DD and the Q&A process (or formal disclosure) between incoming investors and management; and
- the overall alignment between the GP and the secondary buyer in the continuation vehicle.

GPs themselves can also look to line up this process by approaching a broker with the vendor due diligence and looking to flip the policy to the prospective buyer, much like a sell-to-buy flip in standard W&I. By doing this, the GP is able to offer a more attractive, fully warranted portfolio while also capping liability to a low level, thereby freeing up proceeds to exiting LPs.

With the recent progress in synthetic warranty cover, there may also be the ability for the buyers to gain enhanced protection synthetically, without the need to get any contractual protection in this respect from sellers.

Removing deal-blockers from the negotiating table

In recent years, underwriters have evolved from covering only unknown risks in an M&A transaction to having appetite to insure known, flagged risks identified in due diligence. Generally, these risks sit within a low to medium likelihood but with a high potential loss attached.

Identified tax risk is the most established area of this market but underwriters will increasingly look at title, environmental, regulation, pensions, litigation and other risks to insure if they are provided with access to independent verification of the likelihood of the risk materialising and quantum. This market could be using by incoming investors or exiting sellers to remove potential deal-blockers, particularly in a concentrated portfolio or single asset transaction where the specific context may require a degree of protection in excess of the typical cover afforded to secondaries buyers.

Q Are there instances in which it is unsuitable or ineffective?

Insurance is not right for every transaction and the need for it will rest on the potential misalignment between protection desired by incoming investors and the seller's reluctance to take on liability. For insurance to be effective, there must be information available to ensure that insurers have the necessary understanding and analysis to underwrite the deal.

Q Where do you get this insurance and what is the cost compared with other possible alternatives?

The W&I market is established across the world with many different underwriters offering the product. Specialist M&A broking teams help clients navigate this market to make sure buyers get the best coverage at the best price. Pricing will vary depending on sector and geography of the assets but will typically range between 1.5-3 percent of the purchase limit. ■

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