

Utilizing Reps & Warranty Insurance to Facilitate Middle Market M&A Transactions

Moderator:

Terry Bressler, Prairie Capital Advisors, Inc.

Panelists:

Tim Witt, Prairie Capital Advisors, Inc.

David Rubenstein, Drinker Biddle & Reath LLP

Casey Zgutowicz, Lockton Companies, LLC

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Our Presenters – *Moderator*



Terrel Bressler Managing Director

Terry is a Managing Director who focuses on M&A and Capital Advisory engagements. In this role, he assists middle market business owners and their advisors understand and assess their strategic business alternatives and then develop and execute solutions to meet the owner's primary objectives. Typically these solutions include recapitalizations, mergers, acquisitions, company sales and ESOPs. Terry works with family, management owned and private equity owned businesses and helps these clients address their growth and ownership transition issues.

Our Presenters



Tim Witt Managing Director

Tim is a Managing Director who focuses on M&A and Capital Advisory engagements. In this role, Mr. Witt assists business owners and their advisors understand and assess their ownership transition alternatives and design custom strategies that meet the owner's objectives. Strategies typically include company sales to third parties, ESOPs, management buy-outs, family transfers and recapitalizations. Mr. Witt currently focuses the majority of his time executing sell-side M&A engagements on behalf of Prairie's clients.

Our Presenters



David Rubenstein Partner, Drinker Biddle & Reath

David has more than 30 years of experience representing private and public companies in negotiating and consummating scores of acquisitions and dispositions, including mergers, asset and stock acquisitions, and joint ventures. He is involved in transactions across a broad range of regulated and unregulated industries which include a variety of investigatory, tax, accounting and corporate issues.

Our Presenters

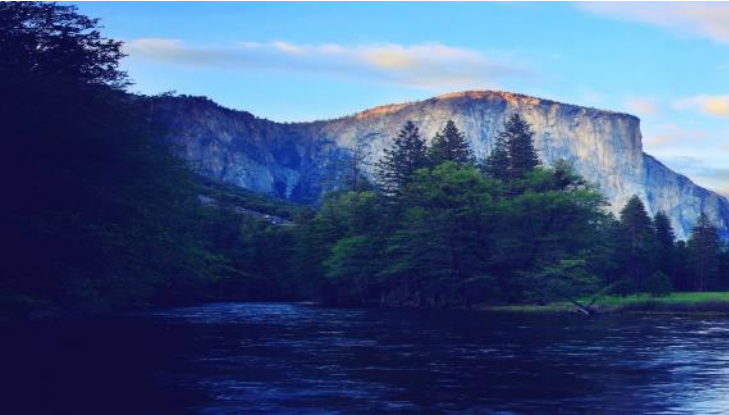


Casey Zgutowicz Vice President, Lockton Companies

Casey has more than 15 years of experience working with senior management teams and private equity firms to design, source and administer their risk management, insurance, employee benefits and retirement programs and has a specialty in M&A and transactional risk.

About Prairie


Serving *Middle – Market Companies*





Prairie Capital Advisors, Inc. is an employee-owned, boutique investment bank focused on supporting the growth and ownership transition of middle-market companies





Company Facts


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Founded in 1996
- 

500+ Middle Market Transactions
- 

Typical Client Revenues: \$10 - \$250 mil
- 

6 Office Locations
- 

40+ Professionals
- 

300+ Annual Corporate Valuations
- 

2nd Ranked Fairness Opinion Provider, *as reported by Thomson Reuters*

AGENDA



Agenda

- What are Representations & Warranties?
- Utilizing Insurance to Mitigate R&W Risk
- R&W Insurance Cost, Terms, Underwriting Process
- Trends in the R&W Insurance Market

What are Representations & Warranties?

- Statements in a purchase agreement regarding the past, present and sometimes future facts relating to the business
- Together with the parties' indemnification rights, representations and warranties serve as a risk-shifting mechanism—inaccuracies may entitle the other party to monetary compensation for associated losses
- Examples
 - Organization and good standing
 - Financial Statements
 - Books and records
 - Inventory
 - Tax matters
 - Employee benefits
 - Absence of undisclosed liabilities
 - Legal proceedings
 - Product liability
- Traditional protections to indemnify buyer – escrowed proceeds

R&W Insurance Statistics

- Significant growth over the past two years
- Statistics from a major R&W insurer:

	2013	2014	2015	2016
Premium Written	\$25M	\$46M	\$140M	\$300M
Number of Policies	45	95	240	350
Percentage of Buy-side vs. Sell-side Policies	80/20	90/10	95/5	99/1

- Lockton Stats:
 - Since 5/01/14: **400+** policies placed and **\$5.1B** in limits
 - 4/30/17 through 9/30/17: **130** policies and **\$2.3B** in limits

NOTE: Strategic acquirers becoming a larger percentage of R&W Insurance Purchasers

Why the Exponential Growth in R&W Coverage?

Acceptance by deal attorneys and strategic buyers

Additional reasons for growth:

- Broader coverage offered
- Streamlined process
- Increase limits of liability
- Reduced premium rates and deductible levels

Tool utilized by sellers to mitigate/eliminate indemnification liabilities (including reducing/eliminating seller's escrow), and to shorten survival periods

GF Data – Fall 2017

- 7.5% of reported deals in 2016, and 34% YTD
- At \$50-250 million TEV, an insurance product figured in 56.4% of transactions in H1 2017

Will the product become a staple onto virtually every deal?

What You Need to Know...

It does not cost anything to get quotes. **All you need is:**

- Draft Purchase Agreement
- Audited Financials
- Deal Book/Description of Business
- Purchase Price*

R&W insurance is not a substitute for comprehensive buyer diligence.

R&W insurance does not cover:

- Known risks
- Exposure areas that are not reviewed in the buyer's diligence process

The market is growing rapidly

- This is not affecting ROLs, which remain steady at 3.0%-3.3%

Claims are being paid

*When the purchase price is below \$20M, R&W Insurance becomes challenging due to the facts that (i) minimum premiums/retentions make it less economically attractive to insureds and (ii) coverage may be more limited/less valuable due to lack of audited financials, less thorough DD, etc. that might happen with smaller transactions.

What You Need to Know...

A unique product – policy can be designed to provide coverage to either:

A SELLER OF A BUSINESS:

for an indemnification claim made by a buyer of the business resulting from a breach of any of the seller's representations and warranties*

*Breach must result from an unknown issue

A BUYER OF A BUSINESS:

for financial loss incurred as a result of a breach of any of the seller's representations and warranties*

*Breach must result from an unknown issue

Commercial and Strategic Benefits:

FOR A SELLER

- Lock in return
- Provide a cleaner exit
- Protect passive sellers
- Reduce obstacles to complete a deal

FOR A BUYER

- Bid competitively in an auction
- Extend survival periods
- Ease collection concerns
- Supplement seller's indemnification

Buyer-Side R&W Policy

- Broader Product
 - Can replace or enhance Seller indemnification
- Buyers want to bid competitively in auction process
 - Buyer can agree to a shorter survival period and/or a smaller cap for reps; a R&W policy will supplement the seller's indemnity package
 - Extend survival period
 - Supplement seller's indemnification
 - Go beyond indemnity cap and survival limitations in Purchase Agreement
- Buyers want to protect key relationships
 - Especially when key sellers stay on as management
 - With key customers/suppliers
 - To ease collection concerns and rely on an indemnity that is backed by an insurance company

Seller-Side R&W Policy

- Limited Use
 - The product can only backstop what has been negotiated in a purchase agreement
- Example of effective use:
 - Heavy Handed Buyer/Protecting Deal Proceeds:
Private company received an offer from a multi-national corporation. Buyer wanted a 20% escrow (\$60M). Seller accepted terms as the purchase price was significantly higher than other offers. Seller backstopped its \$60M indemnity obligation with a Seller-Side R&W policy
- Disparate group of sellers
 - Possibility of joint and several liability. Issue can be addressed by either buyer or seller-side policy

R&W Insurance Continued...

Pricing/Cost

- Premium is a percentage of the limit purchased – typically 3% to 3.3%, or \$30,000 to \$33,000 per million of limit. **Minimum premiums apply (\geq \$140K)**
- Premium subject to tax (ranges from 3% to 5% based on state of domicile)
- Insurers charge diligence fees – range from \$30,000 to \$45,000. These are pass-through costs to outside law firms engaged by the insurer.

Current Challenges

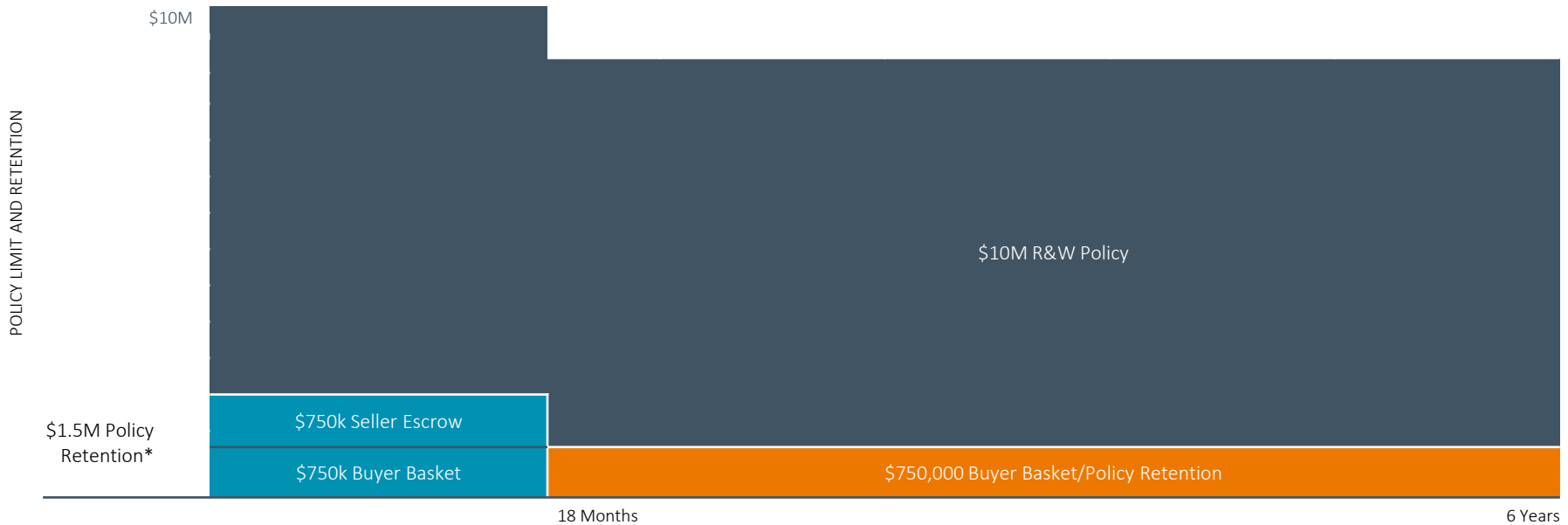
- Enterprise values less than \$25M (minimum retentions of \$300K - \$500K)
- Certain industry sectors (hospital systems; for profit education; some tech with extremely high multiples)

NOTE: Buyer / Seller policy structure does NOT determine which side pays the premium. Current Sellers Market gives Seller leverage to require Buyer to utilize insurance and/or pay premium.

Buyer-Side Policy Structure Example

(including seller indemnification)

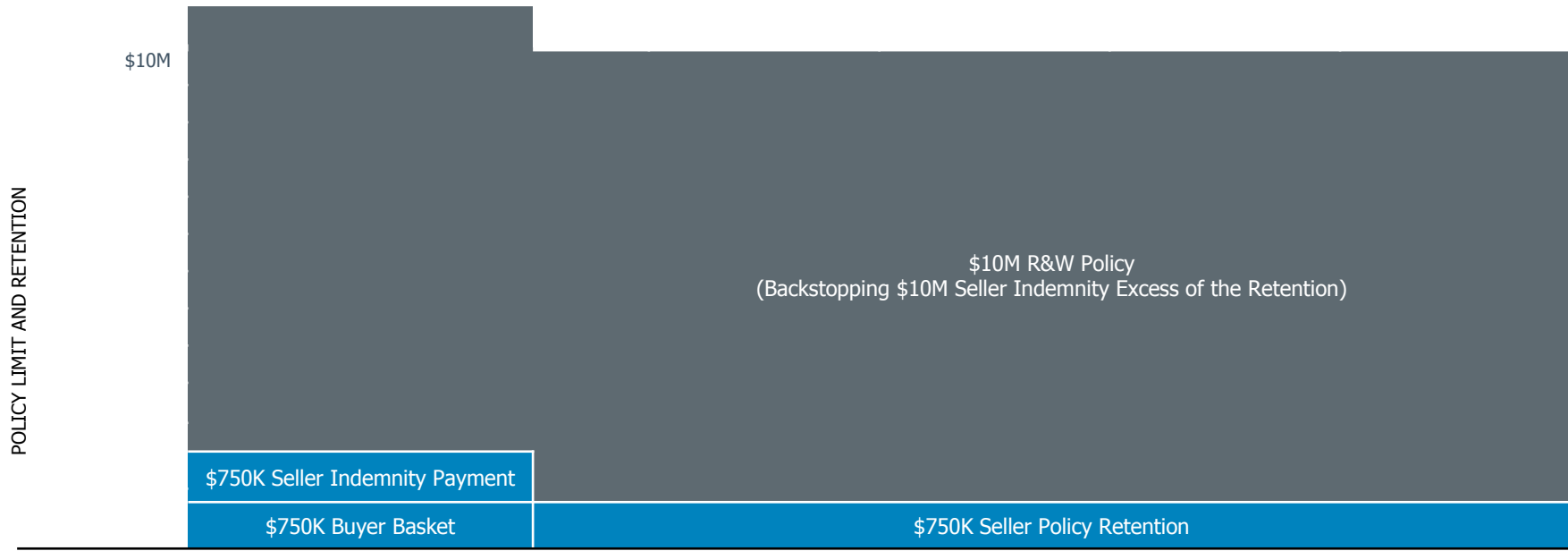
Transactional Value	\$100M
Escrow	\$10M—reduced to \$750K due to policy
Survival	General Reps—18 months; Fundamental, Tax, Environmental, and Employee Benefits—6 years
Buyer Deductible	\$750K
Placement	Buyer-side R&W policy covering general reps for 3 years and fundamentals/tax for 6 years
Policy Limit	\$10M
Policy Retention	\$1.5M first 18 months, then \$750K
Premium	\$325K (3.25% of limit)



*Policy retention is eroded by (i) losses suffered by Buyer under Buyer Basket; and (ii) amounts paid by Seller pursuant to the reduced Seller Escrow. The retention typically drops down after the Seller Escrow is released.

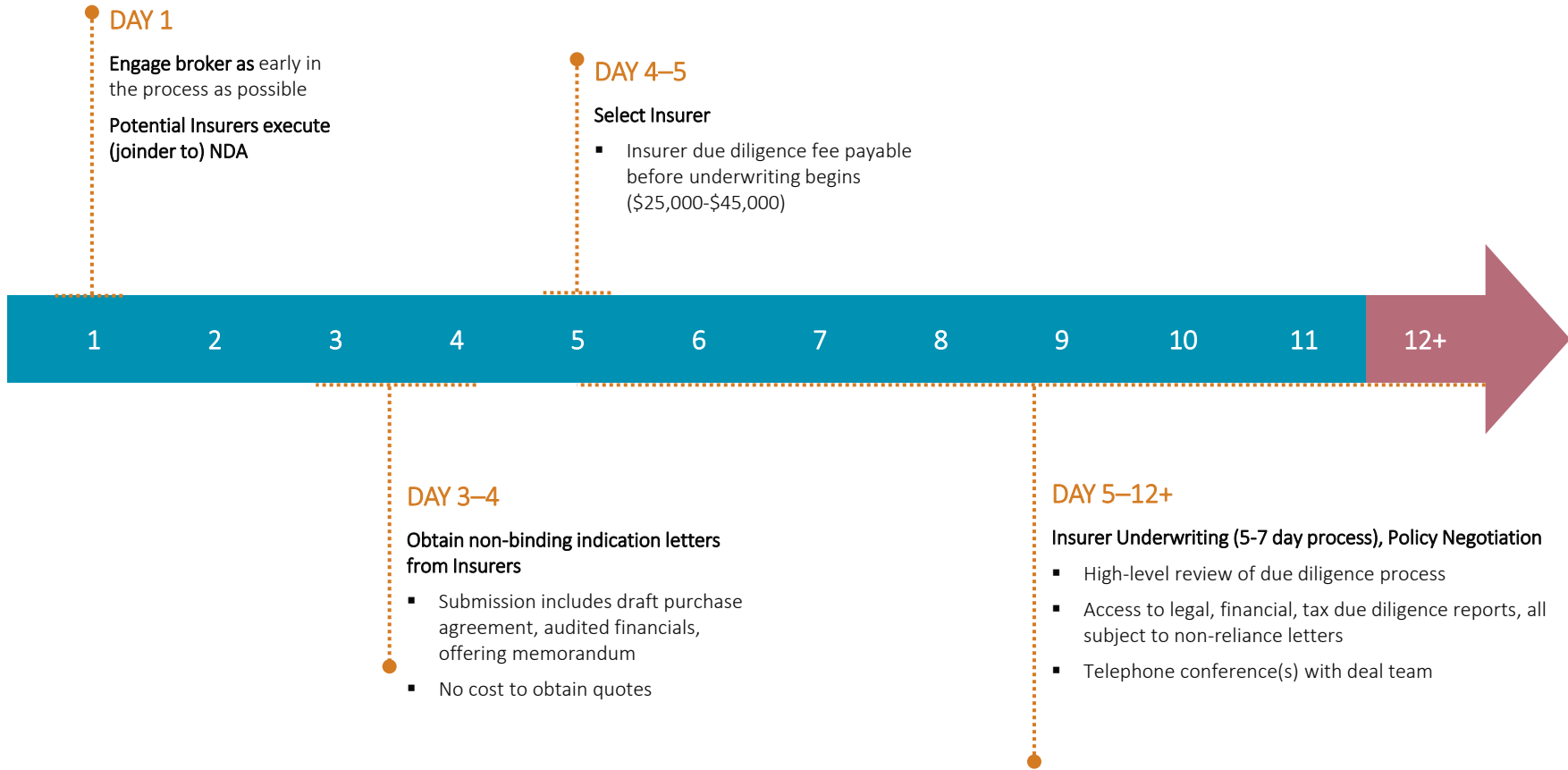
Seller-Side Policy Structure Example

Transactional Value	\$100M
Escrow	\$10M (R&W Policy Backstops the Escrow/Seller Indemnity Excess of the Policy Retention)
Survival	General Reps—18 months; Fundamental, Tax, Environmental, and Employee Benefits—6 years
Buyer Deductible	\$750K
Placement	Seller-side R&W policy covering all reps as per the survival periods outlined above
Policy Limit	\$10M
Policy Retention	\$1.5M
Premium	\$350K (3.5% of limit)



*Policy retention is eroded by (i) losses suffered by Buyer under Buyer Basket; and (ii) amounts paid by Seller pursuant to the reduced Seller Escrow. The retention typically drops down after the Seller Escrow is released.

R&W Insurance: Process & Timing



What About R&W Insurance Claims?

AIG's 2017 Claims Study

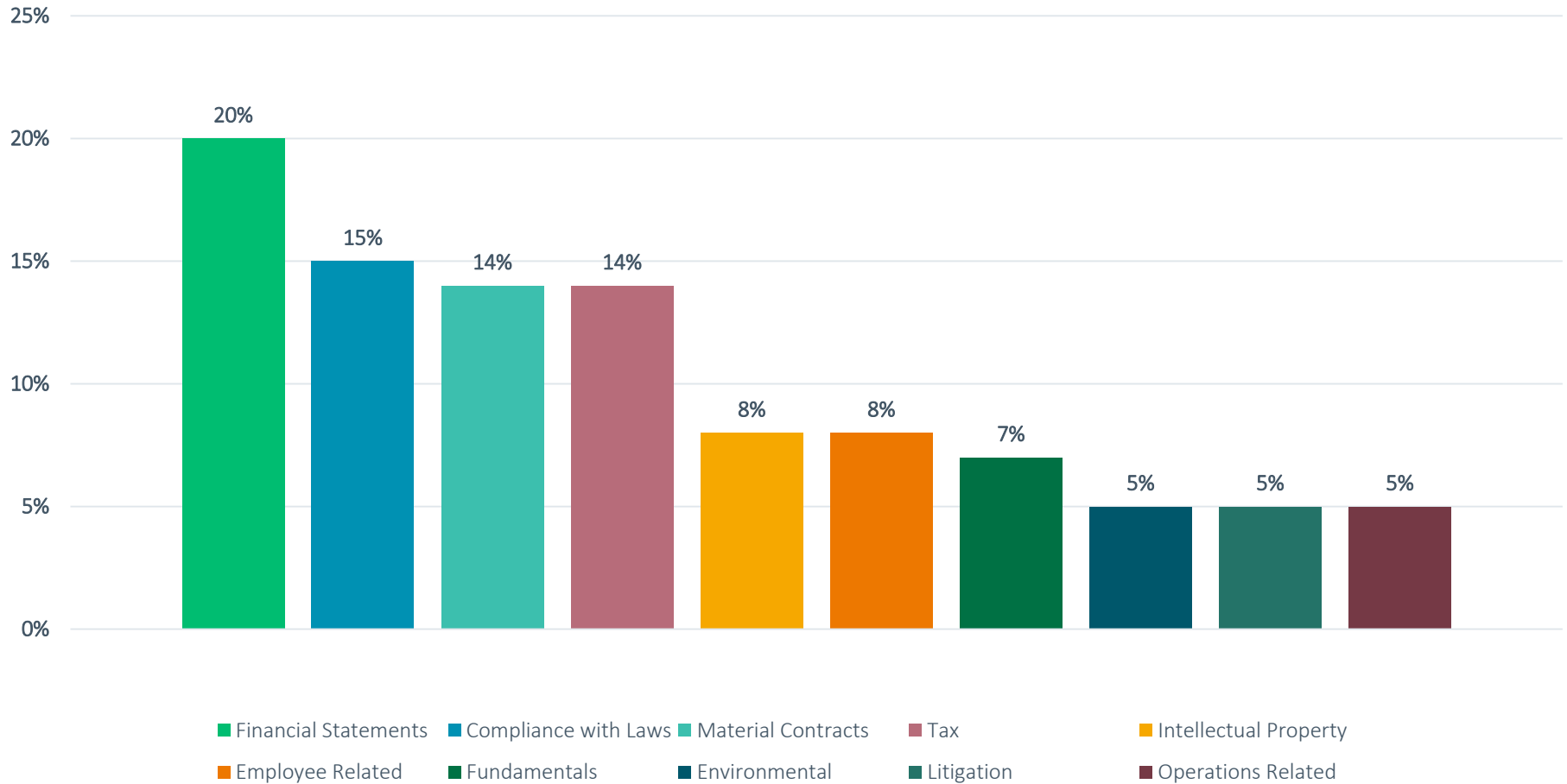
Largely based on claims data between 2014 and 2015, there were approximately 300 claims during this period, covering **1,600 deals** with more than **\$400B** in deal value

Highlights:

- Average claim amount on severe claims is \$20M
- Claims between 2014 and 2015 show that one in four policies written on deals over \$1B resulted in a claim
- 18% of all global policies written between 2011 and 2015 resulted in a claim

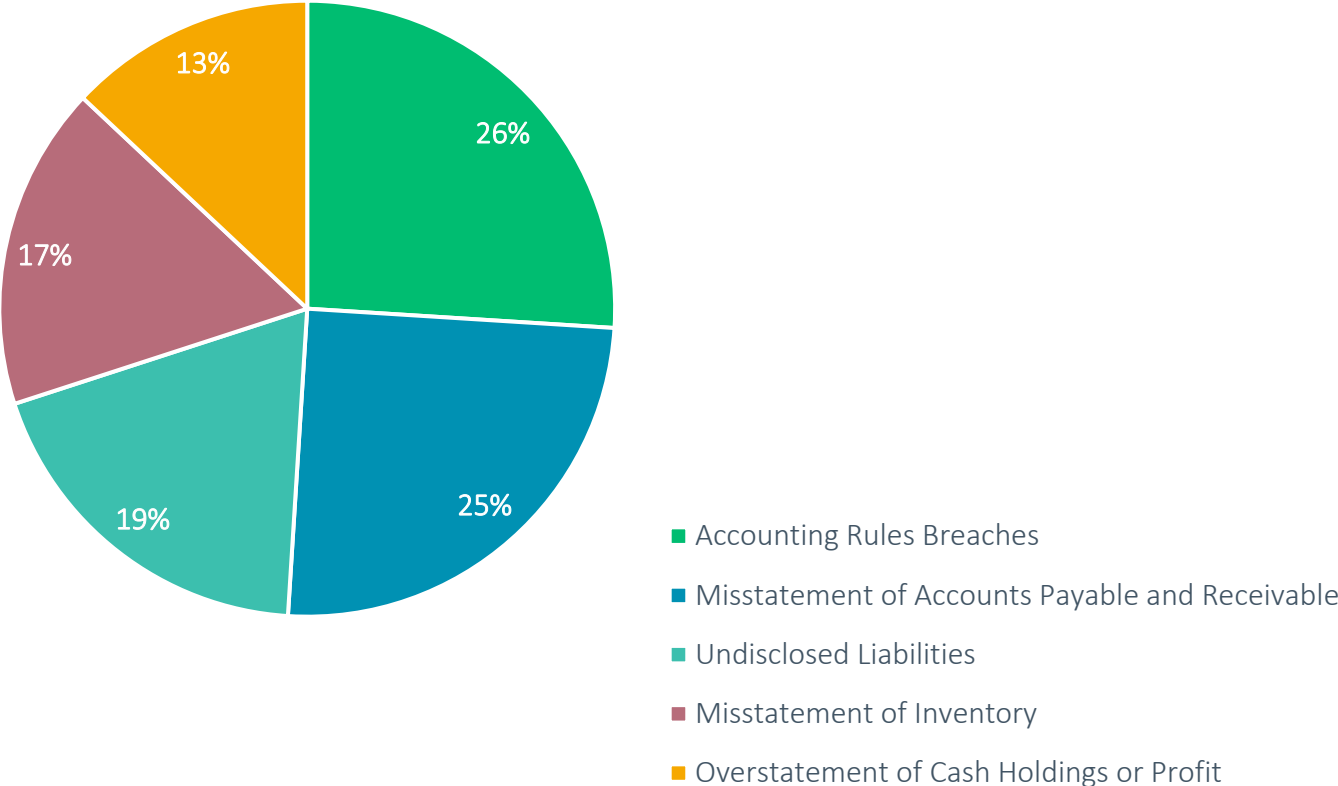
AIG Global M&A Claims Study 2017

R&W Reported Incidents by Breach Type

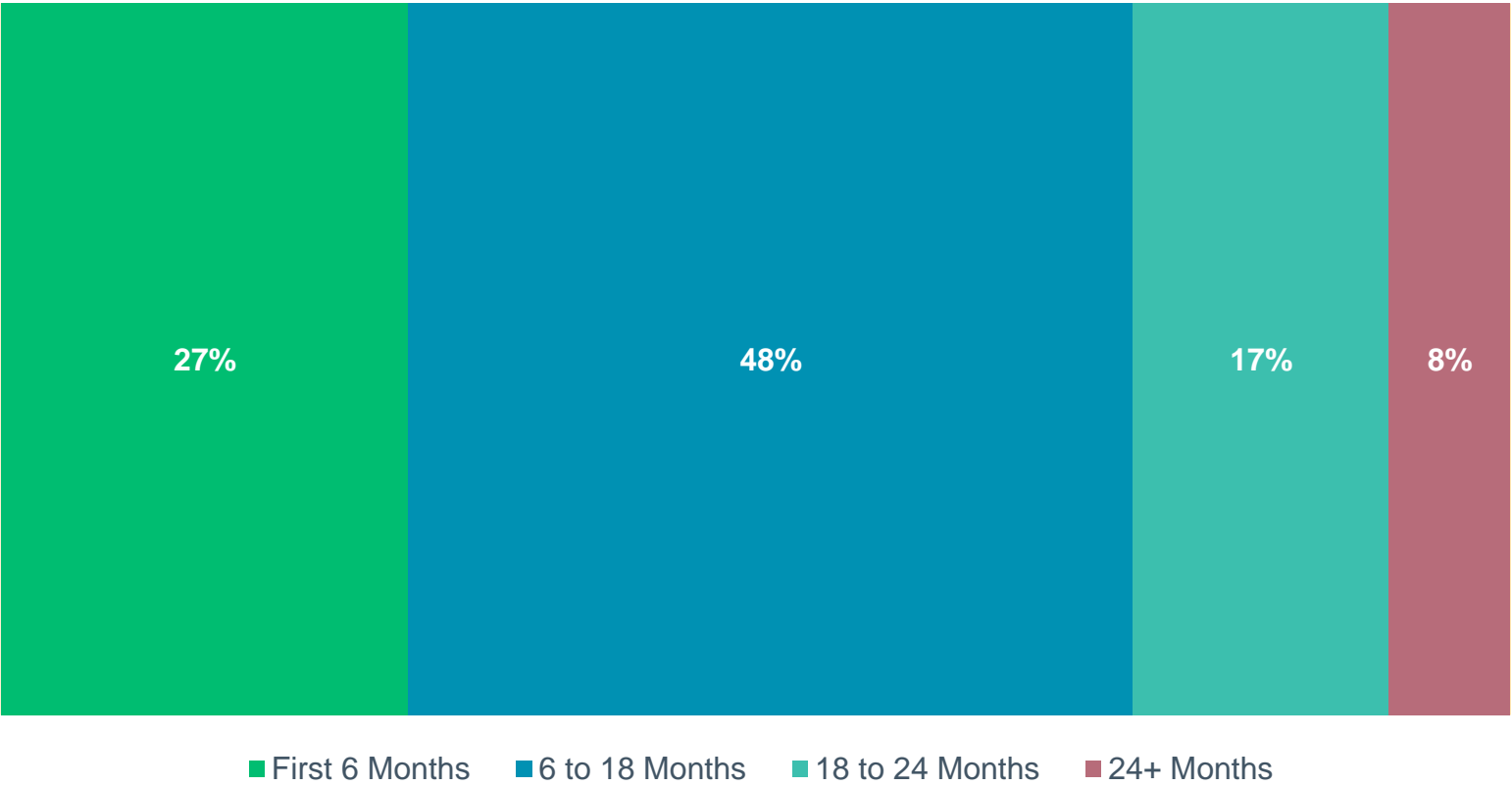


AIG Global M&A Claims Study 2017

R&W Financial Statement Breach Type



Claim Reporting



Other Transactional Risk Insurance Products

Tax Liability Insurance

- Provides coverage against post-closing losses arising out of a specific and known tax issue
 - Can cover the outcome of a tax opinion
 - Can cover a tax issue for which an opinion has not been obtained
 - Can replace (or back-stop) an indemnity in a transaction agreement for a specific tax risk
 - Coverage is also available under a R&W policy for unknown tax issues arising from breaches of tax representations and claims under pre-closing tax indemnities
 - One-time premium ranging between 4% to 8%, depending on facts and circumstances

Contingent Liability Insurance

- Provides coverage (generally to buyer) against post-closing losses arising out of identified contingencies or litigation
 - Insurance ranges between 5% and 20% of the limit purchased
 - These policies are rare (but can be used to mitigate risk/close deals!)

Questions?

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Prairie Capital Advisors, Inc.

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