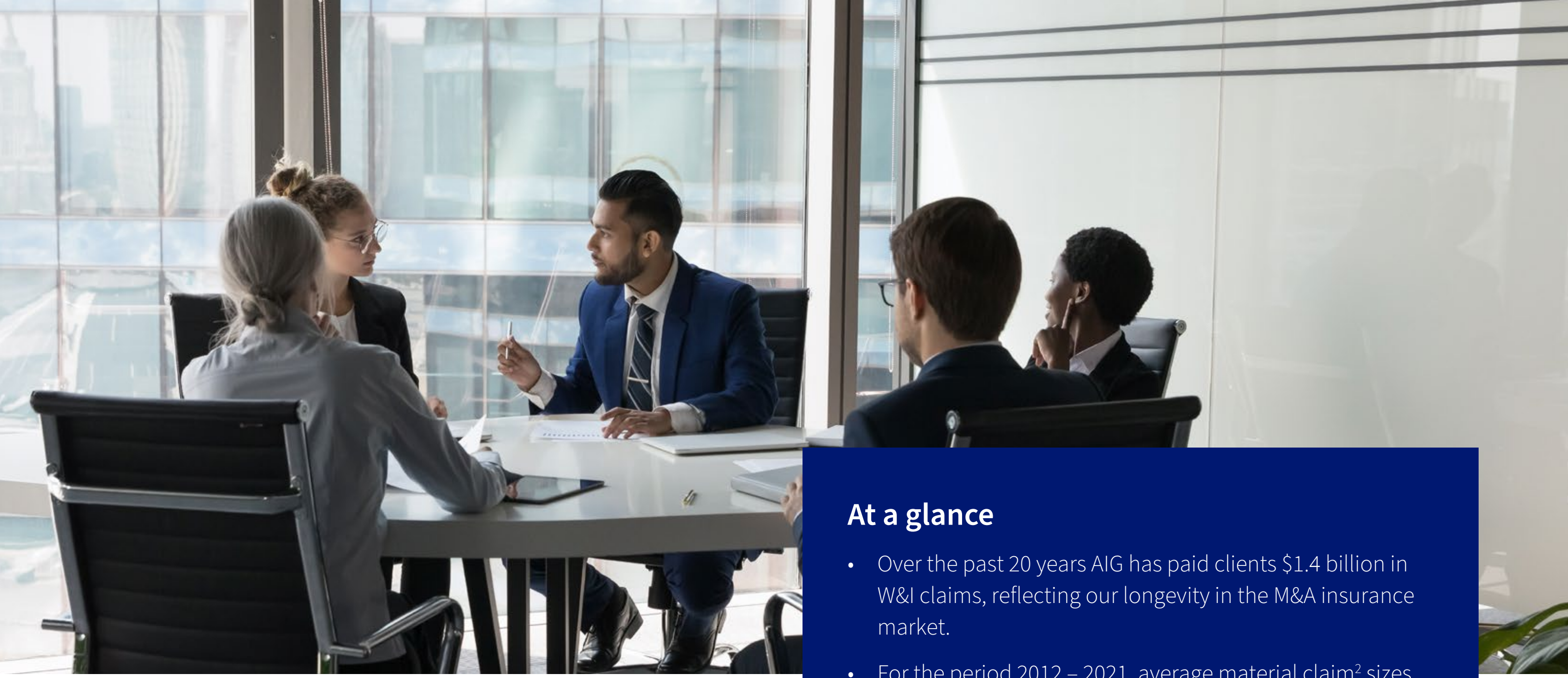
Claims Intelligence Series

M&A: Small Deals and Emerging Markets Drive Claims Activity



At a glance

- Over the past 20 years AIG has paid clients $1.4 billion in W&I claims, reflecting our longevity in the M&A insurance market.
- For the period 2012 – 2021, average material claim[2] sizes remain largely constant across AIG's portfolio. The proportions of such claims remain relatively consistent, showing that large claims continue to be a feature of the M&A insurance market.
- While global claim notification frequency has moderately declined from 1 in 5 to 1 in 6, the number of claims with loss payments has been steadily increasing since 2012.
- Analysis of AIG's claims on smaller transactions with an enterprise value of less than $250m shows that during 2018 – 2021, while 60% of loss dollars came from these deals in this bracket, only 44% of AIG's premium dollars came from those same deals.
- While a meaningful 7% of our global losses have been over $10m, this increases to 38% over $10m among claim payments in emerging markets. This reflects the deal risks involved in these diverse countries.

This seventh edition of AIG's M&A Claims Intelligence report focuses on the significant claims activity on deals at the smaller end of the M&A market as well as highlighting regional differences in frequency and severity[1] of claims.

The dramatic rebound in M&A transactions seen in 2021, as the deal market emerged from the global pandemic, was not sustained during 2022, as macro-economic and geo-political factors all played a part in significantly slowing down global activity. In addition to the geo-political tensions, other pressures such as rising interest rates, supply chain issues, and a general inflationary environment (affecting both labor and other costs) had an impact. This backdrop persisted into the first half of 2023, although in certain parts of the globe there are signs that some of these pressures are beginning to stabilize or ease.

Throughout this quieter period of M&A activity, deal activity in the mid-to-large segment was particularly impacted, as deal parties considered various issues – sellers calibrating the level of acceptable return for their assets, and hoping to achieve a greater exit price if they deferred the timing of their deal – and buyers focusing on other things, such as the cost of debt to fund any available transactions.

The consequence of this dynamic has been an acceleration in trend toward the smaller end of the market or in the emerging markets segment (which for AIG includes Latin America, India, Middle-East, and Africa). This shift was picked up in AIG data between 2018 and 2021, and we expect that moving forward we'll continue to see greater deal and claim activity in these segments. Almost without exception, the limited number of larger deals and deals overall, together with a soft market insurance environment has resulted in terms and conditions and, in particular, policy pricing that is not sustainable in the mid-to-long term.

AIG's longevity in the M&A insurance market, as well as the scale and breadth of our book of business, puts us in a unique position to share insights into claims trends, the use of warranty & indemnity (W&I) insurance,[3] and some of the common deal pitfalls. Over the past 20 years (2003-2023) we have paid clients $1.4 billion in W&I claims.

Methodology

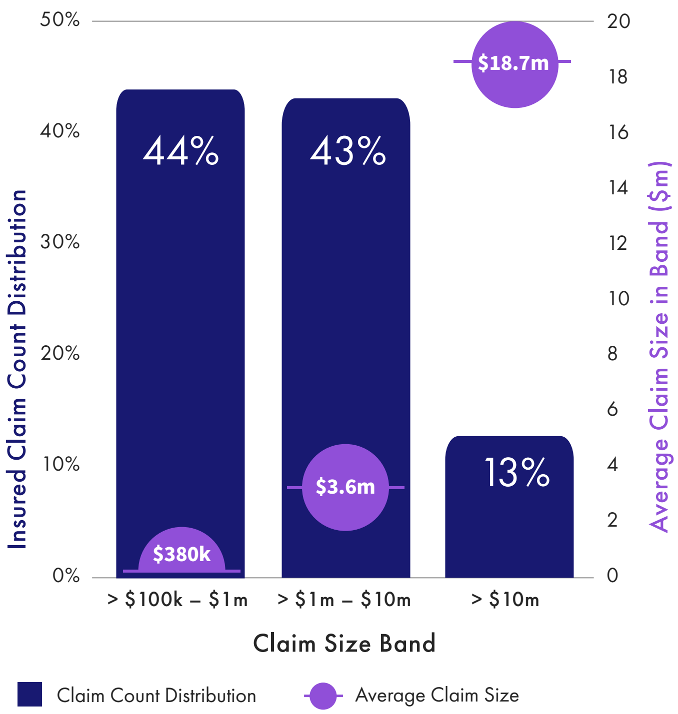
There were over 950 claims made on policies issued during the study period (spanning policies written between 2012 and 2021), relating to over 6,000 deals worth more than $3.7 trillion in deal value – though the number of material claims was smaller. Many policies written during the study period still hold the potential for a claim. Some of the policies have reached or are now reaching maturity, providing us with more intelligence on the complete policy life cycle. The results should not be considered conclusive with respect to the broader context of all private mergers and acquisitions, as not all deals utilize W&I insurance. Nevertheless, the snapshot of W&I claims activity contained in this report provides interesting insights to buyers, sellers, and M&A advisers.

1 Claim severity is the amount of claim payments plus estimated case reserves (i.e. estimated potential future payments on claims already reported provided coverage and loss covered is confirmed) divided by the number of clients receiving claim payments or are expected to receive claim payments in the future on claims already reported.

2 Material claims are claims with an incurred loss greater than USD 100,000.

3 Usually referred to in North America as representations and warranties (R&W).

Fig 1 W&I Material Claims – Distribution of Counts and Average Size by Claim Size Band



Severity

As with prior editions of this claims study, we have analyzed the distribution of material M&A claims globally. For the period 2012 – 2021, average material claim sizes remain largely constant across AIG's portfolio: at $18.7m for the largest claims over $10m, $3.6m for claims of between $1m and $10m, and $380k for smaller claims between $100k and $1m. In addition the proportions of such claims that make up AIG's claim notifications remains relatively consistent, showing that during this time large claims continue to be a feature of the M&A insurance market – and we see such claims in all regions.

Notification Frequency and Loss Frequency

Notification frequency

Due to the market environment, AIG underwrote a significant number of policies in 2021. To date our claims frequency on those deals has not been as high as on policies issued in prior years, (although the policy periods on some of those policies still have a significant amount of time to run such that claims may still be reported). Our global frequency data for all policies globally from 2012-2021 shows a claim on approximately one in six policies, which is down from the one in five policies from prior studies, largely due to this lower claims frequency on policies issued in more recent years.

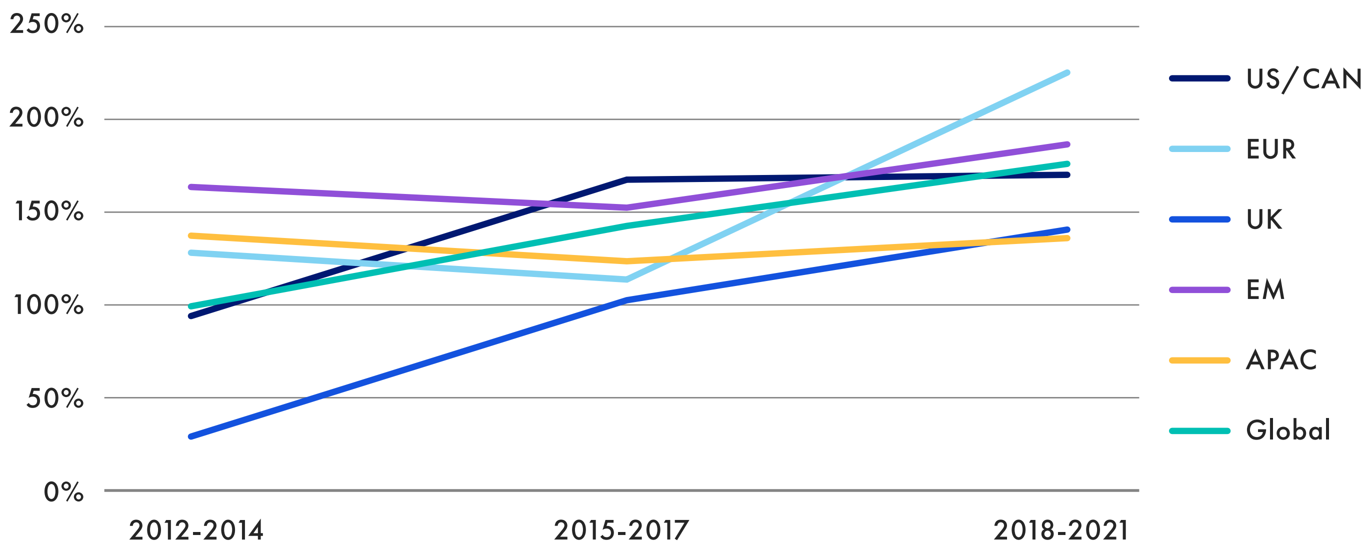
"even if notifications are remaining relatively stable, the number of claims with loss payments has been increasing."

Loss frequency

In this year's study, we want to provide some more context around notifications. It has been widely observed for a number of years now that industry-wide M&A insurance notification rates are relatively stable – but there has been less available information around how that frequency translates into payments. As mentioned above, the frequency of AIG's notifications in recent years has actually decreased, but it is insightful to look at corresponding claims payments over that period, and how that is trending.

In carrying out this analysis of payment trends, we have split our review period into three main bands: policies written 2012 – 2014; those written 2015 – 2017; and those written 2018 – 2021 (all inclusive). The graph below shows the average claims payment loss frequency for each region, relative to our global loss frequency for 2012 – 2014. It is notable that in each region, the frequency of notifications with loss payments is increasing through each subsequent time period. In other words, even if notifications are remaining relatively stable, the number of claims with loss payments has been increasing.

Fig 2 Average Claims Payment Loss Frequency by Region Relative to 2012-2014 Global Loss Frequency



Emerging Markets Claims

AIG is a market leader in M&A insurance in emerging markets. As such, we have learned a lot about the deal risks involved in these diverse countries. Analysis of the distribution of our claims payments for the years 2012-2021 provides some useful insights.

As displayed opposite, on a global basis, 25% of our claims payments have been between $1m and $10m, and 7% have been over $10m – a meaningful amount.

However, in contrasting our global statistics with our emerging markets statistics dramatic differences can be observed, with 38% of our claims payments in emerging markets over $10m. This clearly demonstrates the relatively high risk of the emerging markets segment and illustrates the need for adequate premium rates and prudent limits management strategy in those jurisdictions. We have experienced claims across all of our emerging markets book, with losses coming from a variety of jurisdictions and breach types consistent with what we see on our global portfolio.

Fig 3 Global Losses with Claims Payments Distribution

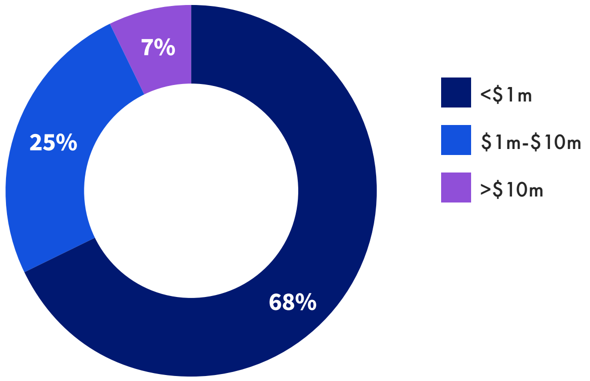
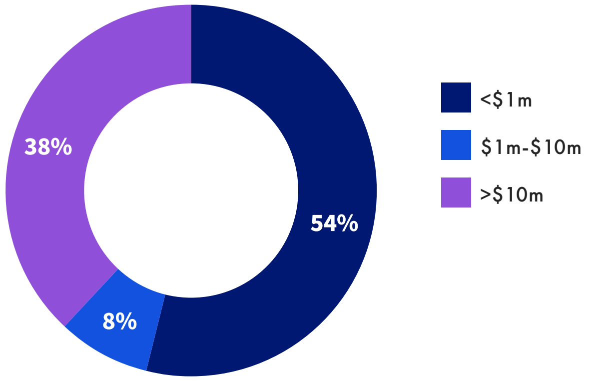


Fig 4 Emerging Market Losses with Claims Payments Distribution



Focus on Smaller Deals

In recent years we have increasingly observed significant claims activity on deals at the smaller end of the M&A market. Analysis of our claims on transactions with an enterprise value of less than $250m shows that during 2018 – 2021 we saw 60% of loss dollars come from deals in this bracket, with only 44% of AIG's premium dollars from those same deals. We have observed many reasons for such claims activity, including:

- More limited internal legal controls in some smaller target companies. This can lead to non-compliance not only with issues like tax legislation, but also with legislation around employment matters, data privacy, and IT licensing.
- A lack of adequate control on financial functions to ensure compliance with GAAP or other applicable accounting standards. This can be exacerbated where the finance function has inadequate oversight. Furthermore, outsourcing of the finance function to a third party can cause issues if there is inadequate oversight. This, combined with a target that might not have a requirement to be audited, could mean that there is no rigorous review of the financial position of the company.
- Lighter touch diligence by the buyer – particularly on the smallest of deals, where insureds can conclude that it makes better economic sense for them to do a "light touch" and take the risk of an issue arising, rather than conducting a more fulsome diligence process. In some cases, this can also mean that they conduct internal diligence, which may result in an outcome that is less comprehensive than diligence conducted by an external party.

AIG's data is clear – multi-million dollar issues (and payments) are not confined to the largest transactions in the market; even some of the smallest transactions see claims, and a number are severe relative to the size of the transaction in question. M&A participants may wish to consider these issues in light of the deals that they are contemplating.

"In the 2018-2021 policy period, we saw 60% of loss dollars come from deals smaller than $250m, but only 44% of premium dollars came from those same deals."

Policy Breach Types

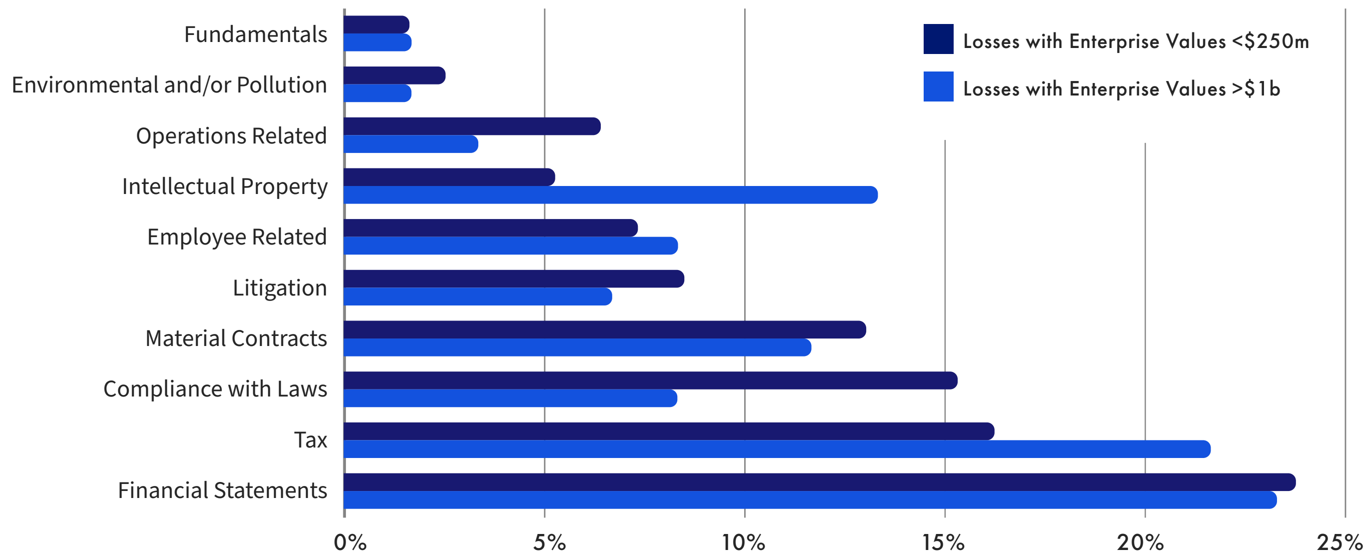
AIG's analysis of breach types provides an overview of the types of claims we see across our portfolio of more recent claims spanning the policy period 2016-2021. In keeping with our focus on smaller deals, we compare and contrast the breaches in this segment with the largest transactions worked on (i.e. those over $1b enterprise value).

On smaller deals there appears to be a higher incidence of breaches related to compliance with laws representations and operations when compared to larger transactions. As previously discussed, we believe this is likely due to more limited internal controls at smaller companies.

It is interesting to note the relative prevalence of claims for breaches of intellectual property (IP) and tax representations for the largest deals – this is likely to be a reflection of the more complex IP portfolios these companies often hold and the more intricate tax affairs these companies inevitably have.

What is notable is the relatively high incidence of claims for breaches of financial statement representations among both deal sizes. For the smaller deals this can be due to their more limited financial control function, whereas for larger deals it can be simply because of their vast scale and/or the complexity of different product lines or geographies being part of a large business.

Fig 5 **W&I Loss Distribution by Breach Type**



Report Lags

By region

We have continued to monitor the timing of our claims notifications, which have remained relatively stable over recent years. The graph opposite, which shows reported claims between 2016 and 2021, illustrates that claims on our emerging markets book have tended to be reported earlier, with 67% being reported within the first 12 months.

That said, we continue to see larger, more material claims reported earlier, so the prevalence of emerging markets severe claims (as discussed earlier) is likely to also show in the claims timing data.

It is also worth noting the relatively large number of claims notified in the UK after 36 months, which have often been tax-related. This reiterates the point about how the tail risk on M&A insurance is real.

By deal size

In keeping with our theme of contrasting different deal sizes, we have also compared report lags on our smallest and largest deals. The chart shows that for the largest deals, claims are all made within the first 24 months, but for smaller transactions, those claims can take longer to come in. This could suggest that there is likely to be a bit more of a tail on the business being written in the current market, and that it will be necessary to wait some time to see how those policy years will ultimately perform.

Fig 6 Reporting Lag Distribution by Region (PY 2016-2021)

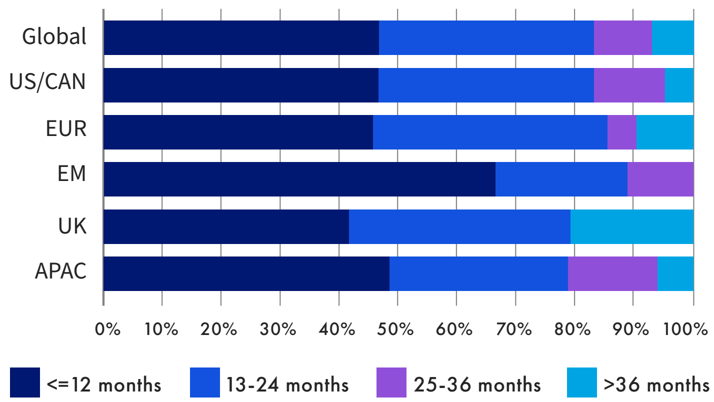
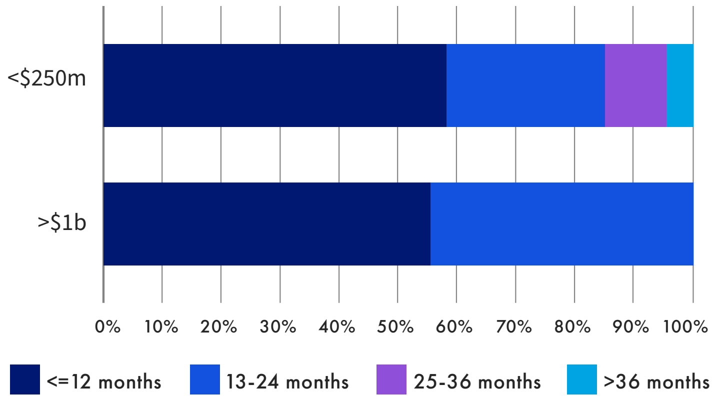


Fig 7 Reporting Lag Distribution by Deal Size (PY 2016-2021)



Case Studies from Small Deals[4]

Inventory breaches

A private equity firm acquired a mid-market provider of outsourced marketing services. Following a post-closing audit, the insured discovered that the target company's financial statements did not comply with its internal accounting policy with respect to inventory. Insufficient reserves were recorded for slow moving and obsolete promotional inventory, including customized inventory, held in connection with several principal customers. The insured loss was several million dollars.

Practice of overcharging clients

The insured buyer acquired a small trial consulting firm from its founders for under $20 million. After closing, the buyer uncovered what appeared to be a practice of overcharging clients. Since those overpayments were not included on the financial statements as liabilities, this practice resulted in an overstatement of EBITDA for the target company. After engaging forensic accounting experts, the ultimate insured loss and the costs and fees incurred by the buyer to pursue legal recourse against the sellers resulted in a limit loss on the W&I policy.

About AIG's M&A insurance team

AIG has been assisting buyers and sellers with approximately 7,000 deals insured globally since the late 1990s. W&I claims can be complex, incorporating difficult issues as diverse as the scope of the warranties insured. When you are facing a significantly large loss on a transaction, you do not want your insurance claims handler learning about how a deal works for the first time. AIG has assembled a global network of in-house claims professionals to manage and resolve these types of claims.

Made up of experienced professionals located in strategic offices throughout North America, UK, Europe, and Asia Pacific, claims handlers work in partnership with the underwriting team. AIG insureds benefit from dealing with knowledgeable claims handlers who understand the complex nature of W&I claims and can focus on the key issues and bring them to resolution expeditiously. With market conditions putting increasing pressure on the M&A insurance market, it is more important than ever for clients to choose an insurance partner that is knowledgeable and tested.

4 The scenarios described herein are offered only as examples. Coverage depends on the actual facts of each case and the terms, conditions and exclusions of each individual policy. Anyone interested in the above products should request a copy of the standard form of policy for a description of the scope and limitations of coverage.

Mary Duffy
Global Head Mergers & Acquisitions
T: +44 (0)20 7954 8104
M +44 (0)7896 822714
mary.duffy@aig.com

Michael Turnbull
Chief Underwriting Officer, Global Mergers & Acquisitions
T: +44 (0)20 7954 8306
M: +44 (0)7395 854 488
michael.turnbull@aig.com

Rita Perez
Head of Financial Lines Claims, NA
T: +1 (212) 458-8713
rita.perez@aig.com

Ami Kalmath
International Head of M&A Claims
T: +61 (0)403 891 949
ami.kalmath@aig.com

Anna Rozin
Head of M&A, North America
T: +1 212 458 1112
M: +1 929 310 2161
anna.rozin@aig.com

Rory O'Broin
Head of M&A, UK
T: +44 (0)20 3217 1718
M: +44 (0)7912 795 104
rory.obroin@aig.com

David Rasmussen
Head of M&A, Europe
M: +45 9132 5136
david.rasmussen1@aig.com

Darren Savage
Head of M&A, Asia Pacific
T: +61 3 9522 4975
M: +61 466 381 434
darren.savage@aig.com

AIG®

www.aig.com

GB0468AR 1123