

The Banker's Guide to Reps and Warranties Insurance Economics

With the explosion of representations and warranties (R&W) insurance over the past few years, there have been numerous legal journals, industry articles, and white papers directed towards educating insurance professionals, investors and lawyers on general policy terms, strategic uses and how the process works. The message typically focuses on the avoidance of escrows as well as returning capital earlier to LP's and/or closing out an end-of-life fund to increase returns. None of these papers have yet to provide any illustrations quantifying what the true financial impact may be in realized terms. In today's current market, the foresight to partner with an experienced R&W insurance broker on both buy

and sell side transactions can drive significant financial benefits, far beyond just insuring potential future risks, by utilizing M&A insurance solutions as another form of 'alternative capital'.

When breaking down the financial impact of using a R&W policy to replace the indemnity and escrow obligations of a seller in a private transaction it is important to first bifurcate the concepts of indemnity (claw-back risk) and escrow (idle funds). While both may have similar financial implications, 'cash is king'. As such, cash escrow or avoidance thereof, can be more easily understood in terms of opportunity cost and return on investment.

Exhibit I

Value \$100,000,000									
	IRR	Acquisition 01/01/2011	01/01/2012	01/01/2013	01/01/2014	Closing Funds 01/01/2015	Escrow Release 01/01/2016	01/01/2017	Total
W/O Policy	16.02%	\$85,000,000	Hold Period			\$90,000,000	\$10,000,000		\$100,000,000
W/ Policy	17.36%	\$85,000,000	Hold Period			\$99,333,750	\$500,000		\$99,833,750
Increased IRR	1.34%					\$9,333,750	(\$9,500,000)		
Initial Escrow 10%		Duration (mos) 12		Policy Rate 3.50%		Insurance/Escrow 95%		Cost of Policy* (\$166,250)	

Value \$100,000,000									
	IRR	Acquisition 01/01/2011	01/01/2012	01/01/2013	01/01/2014	Closing Funds 01/01/2015	Escrow Release 01/01/2016	01/01/2017	Total
W/O Policy	14.64%	\$85,000,000	Hold Period			\$80,000,000		\$20,000,000	\$100,000,000
W/ Policy	17.08%	\$85,000,000	Hold Period			\$98,667,500		\$1,000,000	\$99,667,500
Increased IRR	2.44%					\$18,667,500		(\$19,000,000)	
Initial Escrow 20%		Duration (mos) 24		Policy Rate 3.50%		Insurance/Escrow 95%		Cost of Policy* (\$332,500)	

*Cost is split with Buyer

Exhibit I illustrates the increased internal rate of return (IRR) to investors for a single investment however does not account for increased intangible value based on the reduction of claw-back risk and the certainty of proceeds associated with potential future losses that are now avoided.¹

Indemnity

A Seller's indemnity obligation, as it relates to breaches of reps and warranties, can be viewed as Seller's claw-back or 'tail' risk of potential post-closing losses related to breaches of the representations and warranties made by the Seller(s) regarding the company. Using the average indemnity limit of 10% for non-fundamental reps (often referred to as the 'Indemnity Cap') measured as a percentage of enterprise value², under a given \$100M transaction, a Seller would be expected to provide a Buyer with indemnification for potential post-closing losses up

to \$10 million. The Seller is typically on the hook for this Indemnity Cap for a period of 12-24 months (the 'Survival Period'), and therefore must account for this potential claw-back risk in the total proceeds distributed to LP's/ investor's as the Buyer will maintain legal recourse against the Seller should such losses occur within this Survival Period. This indemnity risk can have a significant impact on the certainty of proceeds, return on investment, and, ultimately, the ability to close out a fund and return capital to investors.

¹ [IRR calculation using a \$100m transaction with an assumed 10% escrow equal to a 10% indemnity cap and replacing the escrow completely while reducing the indemnity cap to 0.5% (insurers generally require some minimal seller indemnity) by providing a R&W policy to provide the buyer with the same 10% protection.]

² [2013 ABA Private Target Mergers & Acquisitions Deal Points Study]

Escrow

In order to secure recourse for these potential indemnity losses, a Buyer will frequently require an 'Indemnity Escrow' or request a 'Holdback' which limits the actual proceeds received by Seller(s) immediately at Closing. The average Indemnity Escrow is generally lower than the Indemnity Cap, at 7% of enterprise value², but in many cases will match the full Indemnity Cap. The Indemnity Escrow is funded by the Buyer using cash proceeds from the purchase price and is typically maintained for the same 12-24 month Survival Period.

As financial sponsors look to realize an investment, these funds sitting idle (whether in escrow or holdback) can have a significant financial impact on the internal rate of returns (IRR) and reinvestment or opportunity cost (ROI used for purposes of illustration). By providing the Buyer with an R&W policy in lieu of traditional indemnification limits, a Seller can, in most cases,

Exhibit II

Assumptions - R&W Policy Economics	(\$MM's)	(\$MM's)
Enterprise Value	\$100.00	\$100.00
Escrow Account Fee (% Return)	0.50%	0.50%
Escrow (% of Enterprise Value)	10.00%	20.00%
Duration of Escrow (months)	12.00	24.00
Internal Rate of Return (Hurdle Rate)	15.00%	15.00%
Insurance Limits Purchased (% of Escrow)	95.00%	95.00%
Cost of R&W Policy (% of Limits)*	1.75%	1.75%
Escrow Avoided (R&W Policy Limits)	\$9.50	\$19.00
FV of IRR on Escrow Avoided (Opportunity Cost)	\$1.43	\$6.13
FV of Escrow Account Fee (Lost Returns from Escrow)	(\$0.05)	(\$0.19)
PV of IRR on Escrow Avoided (Opportunity Cost)	\$1.24	\$4.63
PV of Escrow Account Fee (Lost Returns)	(\$0.04)	(\$0.14)
Subtotal	\$1.20	\$4.49
Cost of R&W Policy (Premiums)	\$0.17	\$0.33
Value Created (as a % of Enterprise Value)	\$1.03	\$4.16
Incremental ROI	1.03%	4.16%

*Cost is split with Buyer

Exhibit II demonstrates the opportunity cost in net present value (NPV) assuming that LP's and GP's are serial investors and will reinvest the escrow avoided with an expected IRR of 15%.

eliminate an escrow/holdback and effectively create value far beyond that of the opportunity cost of the R&W policy (often split between buyer and seller).

M&A bankers are becoming more comfortable with using R&W insurance as a strategic tool to deliver accretive value to their clients. However, engaging a R&W insurance advisor with extensive knowledge and experience providing direction to bankers, investors and representative counsel on the potential structures of a private transaction agreement (escrows, indemnities, caps, baskets, recourse, etc.) to match the mechanics of the R&W insurance policy is truly vital in capturing the financial benefits. Policy terms can vary greatly depending on the R&W broker, selected insurer, and deal team tasked with structuring the policy alongside the transaction agreement. With just a small handful of professionals with the requisite expertise, adding a R&W insurance broker as a trusted advisor to the core M&A deal team for the long haul is already paying dividends to those early adopters.





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Mr. Sanderson has more than 10 years of M&A and transaction advisory experience and is responsible for overseeing the Transaction Risk / M&A Insurance Practice at Equity Risk Partners. Mr. Sanderson directs the strategic planning, business development and delivery of Transaction Risk programs, such as representations and warranties insurance, tax liability and tax credit insurance, and other contingent liability insurance solutions on behalf of Equity Risk's private equity, corporate and legal clients.

Prior to joining Equity Risk Partners in 2014, Mr. Sanderson spent 7 years in Aon's M&A Solutions (AMAS) group, most recently helping build Aon's Transaction Solutions team focused primarily on structuring representations and warranties insurance for Aon's private equity, legal and

corporate clients. Mr. Sanderson's previous responsibilities at Aon included leading the strategy and innovation for the Global M&A Solutions team, a \$120M global practice group, through corporate development, business transformation and other high-profile client and product delivery initiatives.

Mr. Sanderson was a recipient of the 5th Annual 40-Under-40 M&A Advisor Recognition Awards for his contribution to the M&A community through structuring representations and warranties insurance solutions and has been a speaker and panelist at the Association for Corporate Growth (ACG) and other numerous events in regards to his knowledge in this space. Mr. Sanderson graduated with an MBA in Strategy and Finance from Bentley University.

Equity Risk Partners is a full service insurance brokerage and risk management advisory firm that provides global solutions to help companies and individuals manage risk. Equity Risk Partners is the only insurance brokerage with an exclusive focus on the private equity and M&A industry as it relates insurance and transactional risk needs. For private equity firms, Equity Risk Partners conducts due diligence on the insurance and employee benefits programs of investment targets as well as structuring transactional risk solutions to help buyers and seller realize additional returns in a transaction through replacing/eliminating traditional indemnification and/or escrow with an M&A insurance policy, most commonly using representations and warranties insurance.

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