CAC Specialty™

Representation and Warranty Q1 2020

MARKET Update

Newsletter www.cacspecialty.com

#CACSolved: A Look at the 2020 R&W Insurance Marketplace

Representation and Warranty Insurance ("RWI") continued its meteoric growth in 2019.

Underwriters tackled deals in industries and at enterprise values beyond the market's previously perceived outer limits. Rates for most deals have settled in at 2.5-3% of limits for the first 10% of EV. At the same time, insurers are increasingly facing above-retention claims (which will be the subject of a future #CACSolved update).

Looking forward, we want to review what we learned from the insurance markets in 2019 and what we're watching for this year.

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The Range of Deal Sizes Where Parties Use RWI Continues to Expand:

Deal parties are increasingly using RWI in deals that were once viewed as either too small or too large for insurance to add meaningful value.

Small EV Deals

- The reps and warranties in deals between $10M and $25M in EV are now often insured, and many more insurers are actively competing to win these transactions.
- Compared to the $5M limits floor imposed by many insurers in the past, competition in the market is pushing insurers to offer cost-effective policies with only $3M and $4M limits.
- Minimum premiums for these policies range from approximately $100K to $140K, depending on the industry, the target involved, and other deal dynamics.
- Minimum initial retentions range from approximately $200K to $250K, dropping to even lower amounts 12 months into the policy period.
- Many of these small transactions involve targets without audited financial statements, in which case underwriters carefully focus on the buyer's diligence related to the financial statement reps.

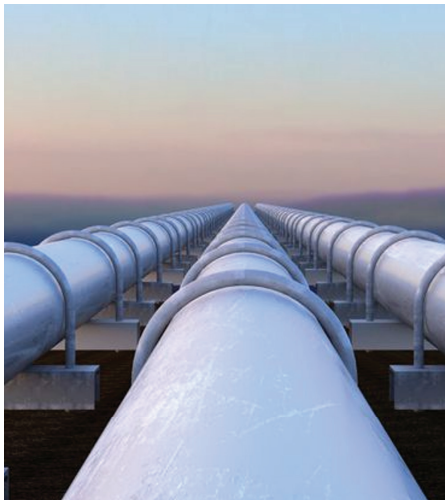
Large EV Deals

- On the other end of the RWI deal spectrum, new flexibility on retention levels and improved blended rates for large towers (in particular, a competition-driven decrease in rates for excess coverage) have considerably increased the use of RWI in large deals.
- RWI is being used in many deals with EVs of more than $1B.
- For transactions above approximately $250M, initial retentions below 1% of EV are now commonplace, and in deals above $1B, insureds can expect a considerably lower initial retention.
- The market now offers billions of dollars of RWI capacity for a single transaction.

"Risky Industry" Deals Increasingly Utilize RWI

One of the most exciting updates in the market right now is deals in industries that insurers previously viewed as too "risky" or too complex for RWI are now being insured, and sometimes on very favorable and reasonable terms.

Placing good RWI policies in these areas — ones that provide real value and don't leave gaping holes in coverage — requires market expertise and deal experience. The following industry updates are borne out of our own, and we continue to evolve and grow to stay ahead of the RWI market's fast evolution.



Oil Field Services:

RWI is commonplace in oilfield service deals. These deals are (perhaps unsurprisingly) treated just like any other RWI deal. Pricing and diligence obligations track what you'd see in most manufacturing deals, with particular underwriting emphases on employee matters (including classification), potential environmental issues, and customer / supplier relationships and contracts, among others.

Midstream Transactions:

With the large number of PE buyers and sellers in the midstream O&G market, RWI has become the norm in these transactions over the last 18-24 months. Initially, we saw insurers trying to limit coverage for the condition of assets rep and exclude environmental coverage altogether, but that's no longer the case. Reasonable diligence on the condition of the assets and an explanation of those efforts — and without unrealistically requiring physical visits to every inch of a pipeline — should result in coverage for that rep. Insurers also regularly cover environmental reps. While RWI typically limits its coverage to being excess of and no broader than an underlying pollution legal liability ("PLL") policy, in 2019 we successfully placed at least one policy where the insurer was willing not to so limit the RWI policy's coverage of environmental reps. Not surprisingly, the underwriter in that case required fulsome environmental diligence, including Phase I reports for each of the relevant sites.

Upstream / Minerals:

Until the past year, RWI was used exceedingly rarely (if ever) in upstream O&G deals and did not provide any coverage for environmental or title matters. That changed in 2019, and we expect the momentum to continue this year. We have now placed policies in upstream deals that offer coverage of environmental compliance reps with normal diligence and environmental contamination reps excess of underlying PLL coverage. Moreover, some insurers will now cover the special warranty of title to provide buyers with post-closing protection for title defects that arose by, through, or under the seller. This coverage incepts at closing, after the standard title diligence period. This is a huge shift in the market. A few insurers are trying to establish themselves as leaders on these deals. Typically, coverage in upstream deals is a bit more expensive and commands a higher underwriting fee ($40-60K) in light of the expertise required to effectively underwrite the buyer's diligence related to title, environmental, and other industry specific matters.

Healthcare:

RWI is now commonplace in healthcare M&A – even coverage for once-uninsurable targets and for once-uninsurable risks, if you know where to find it.

Encouragingly, underwriters have invested significantly in hiring and retaining experts in the healthcare space, so RWI market supply is catching up with healthcare M&A industry demand.

Pricing runs similar to other industries, though the subsector of healthcare drives variances. That said, it's an update in itself that the difference between a healthcare subsector perceived by RWI underwriters as straightforward (e.g., dermatology roll-ups) and a subsector previously perceived as too risky to insure (e.g., home health / hospice, surgical centers) is a difference in pricing, not in availability of coverage. Indeed, in 2019 we placed policies in deals in both of those "risky" areas.

Perhaps most importantly, coverage in even the tougher subsector can now extend to reps relating to tough healthcare-specific risks such as:

- Government and private-payor billing & coding
- Regulatory compliance / AKS / Stark
- HIPAA / cyber / patient data risks
- Medical malpractice
- Corporate practice of medicine

Finally, clients are increasingly seeking significant excess limits (up to 40% or more of the EV) for healthcare matters representations, and the market is readily offering that coverage.

Cannabis:

It seems like everywhere you turn cannabis is a hot topic, and the RWI market is no exception.

We are aware of some markets dipping their toes in this space, but they are very picky about which specific deals and the exact types of underlying businesses associated to the transaction.

Based on our review, RWI can be available in cannabis-related deals in the following subsectors, with 1 being the easiest to place (but still not easy compared to other industries) and 5 being perhaps the most difficult RWI placement in the market today.

1. Non-leaf touching, cannabis-related businesses (e.g., vapes/paraphernalia manufacturers etc.)
2. Other services/support businesses that do not actually sell cannabis in any capacity
3. CBD or hemp-only businesses
4. Medical-only US cannabis businesses and Canadian growing/manufacturing
5. US-cannabis growers

Additionally, most underwriters offer lower limits in cannabis related RWI deals (less than $20M per carrier) as underwriters are sensitive to managing their broader exposure to the industry. Like many other industries, market appetite changes fast and is driven by live-deal opportunities, so it's often beneficial at least to explore the possibility of RWI.

Thank You from CAC Specialty!

Lastly, we want to thank you all for your support as we launched CAC Specialty. We built this company because we know that delivering unparalleled service and expertise to clients, and putting their interests above all else, will give our clients the best value they can find in insurance.

As our team and client list continues to grow, we're confident this approach is the right building block for our company. Our tagline is #CACSolved and that's our focus: we want to help solve your problems. We're proud of what we're building and we're growing every day; we know we couldn't have done it without you. Thank you!

Expanding what's possible for solving risk challenges – from the simple to the previously unsolvable.

ABOUT CAC SPECIALTY

CAC Specialty is a risk solutions company of seasoned and proactive senior industry leaders, operating as a nimble and collaborative partner who puts you and your business first. With a knowledge-driven approach informed by data and decades of honed instinct, CAC Specialty brings an innovative vision to insurance broking and structured solutions to solve your risk challenges – from the simple to the previously unsolvable.

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