

RISK FOCUS

REAL ESTATE BULLETIN OCTOBER 2017

Real estate M&A- insuring your way to a better deal

With real estate investment in Europe having risen by 25% to EUR 74 billion by the second quarter of this year,¹ it is even more important that investors are alive to the developments within merger and acquisition (M&A) insurance and how these products are being used to strategically facilitate and enhance deals.



Whilst these M&A products are not new, increasing competition and broker specialism has seen rapid development and improved process efficiencies resulting in a circa quadrupling growth in demand in the last six years.

The real estate sector leads the pack in the use of these products and it is now commonplace to see the underlying transaction structured around the use of insurance with the seller retaining no, or only nominal, liability post-completion. This has enabled investment funds to return dividends without holdback for potential warranty claims and has also facilitated fund liquidation.

Typical insurances taken out on real estate deals include:

- **Warranty & Indemnity (W&I)** - insurance to protect against unknown breaches of warranties in the sale agreement.
- **Tax-** insurance to ring fence against identified potential tax liabilities e.g. Stamp Duty Land Tax (SDLT) and VAT matters.
- **Environmental-** insurance including cover for legal liability and the clean-up costs associated with pollution.

- **Title Top-Up-** insurance cover for breaches of fundamental warranties up to 100% of enterprise value (EV).

This increased demand for these products has led to huge growth in capacity (circa five times that available six or seven years ago), such that it is possible to pull together well over USD 1 billion in policy limit for any one transaction. This growth has resulted in downward pressure on both pricing and policy excess levels.

¹<https://www.cbre.com/research-and-reports/2017-Global-RE-Market-Outlook>

JLT's M&A Index has tracked this downward trend over the last three years:

GLOBAL REAL ESTATE DEALS (excluding North America)

	Real estate as % of M&A deals	Premium rate (average)	Excess (average)	Limit (average)
2015	33%	1.45%	0.31%	19.43%
2016	29%	1.24%	0.39%	26.26%
H1 2017	27%	1.13%	0.24%	28.36%

It is interesting to compare this data with UK real estate deals only, where the impact of Brexit can be clearly seen in 2016, as can the abundant availability of nil policy excess options.

UK REAL ESTATE DEALS

	Real estate as % of M&A deals	Premium rate (average)	Excess (average)	Limit (average)
2015	46%	1.35%	0.56%	16.74%
2016	14%	0.98%	0.10%	16.74%
H1 2017	27%	0.98%	0.00%	20.32%

This overall rating reduction is all the more noteworthy as we are starting to see insurers include cover for certain low-risk tax exposures, which may previously have been excluded and/or charged for separately under specific tax policies.



WHAT'S NEW?

- On pure real estate deals (with limited operational exposures), it is now possible to achieve a nil policy excess, meaning that the buyer does not have to suffer a financial loss (aside from nominal de-minimis) before making a claim under the policy. Falling premiums, nil policy excess levels and wider coverage are all having a direct impact on the underlying profitability of investments.
- Almost every real estate deal will have a potential inherent structural tax exposure that will be flagged by advisors as part of the due diligence (DD) process. Increasingly, insurers are willing to provide affirmative cover for both residency and trading versus investment risks within the W&I policy, assuming that advisors have deemed these matters to be low risk. Previously, coverage for such matters was excluded or at best ambiguous, or covered separately under a specific tax policy for an additional premium.
- Many of the W&I insurers are now able to include title top-up within the W&I policy at much reduced rates. This is particularly relevant in circumstances where the selling fund is looking to liquidate shortly after completion.
- Continual innovation within the marketplace has enabled us to offer solutions to clients looking to wind up funds that still have residual risks sitting within them. It is possible to structure insurance to wrap around legacy liabilities (including tax positions) that are still live. It is also possible to seek separate but related cover from the title and legal indemnity market to address any of the previous sales where a full title guarantee was given.

NEW PRODUCT

AIG has recently entered the real estate market with the launch of their Real Estate Guard product. Whilst this incorporates covers that have been separately available for a short while, AIG are the first insurer to bring them all under one product and for a single pre-agreed price. The product is aimed at Grade A commercial UK properties located in major cities with EVs of circa GBP 25 million to GBP 500 million.

The product includes cover for:

- W&I with a nil policy excess
- Affirmative tax cover for both residency and trading versus investment risks
- Tenant default coverage
- Environmental protection
- Title top-up.

The policy can be agreed and issued within four business days from receipt of all transaction documents.

This combined offering is already proving a useful tool in enabling investors to obtain competitive deal financing.



FOCUS ON TAX

With heightened scrutiny on the tax affairs of investment funds, investors are becoming increasingly reluctant to carry potential liabilities (either as buyer or seller). This aversion has come at a time when the M&A insurance market is more able than ever to look creatively at such deal obstacles and take them off the table.

We have already discussed the fact that insurers are more willing to include low grade tax risks for trading versus investment within the scope of the W&I policy, but there remain related exposures which give rise to greater concern, including more recent rules around transactions in UK land. This is a similar but more concerning point that can land a tax charge on a buyer for the seller's gain and we see buyers pushing sellers to pay for policies to ring-fence this risk.

A recent win by HMRC on a residency case is forcing advisors to consider how well this has been managed internally and seeking recourse in the event that HMRC find the facts questionable.

TAX CASE STUDY

Our client was bidding (in a highly competitive auction) for a prized UK property which was being sold by a liquidator on behalf of a major financial institution.

As part of the DD process, advisors had identified a significant potential VAT risk sitting in the company (maximum exposure was circa one third of the total EV). Although the chance of the loss crystallising was remote, it was a risk that the fund was unable to carry.

Although our client did discuss making their offer inclusive of VAT, the liquidator was unwilling to retain the risk. Our client came to us and asked if we could structure an insurance solution to ring-fence the risk. Although theirs was not the highest bid, our client was granted exclusivity because they were the only bidder who came up with a solution that took the VAT matter off the table.

We ultimately received instructions to proceed with just three days to close the deal. Our M&A team successfully placed a fully negotiated tax liability policy ahead of the deadline. This was a significant deal for both our client and the liquidators, who were equally delighted and said that the deal could not have gone ahead without the insurance.



FOCUS ON CLAIMS

Whilst this class of business has always previously been profitable for insurers, increased competition has had a negative impact (for insurers) on pricing, attachment points and scope of cover, such that levels of claims activity have increased dramatically with some insurers running at close to 100% loss ratio.²

At present, there is no immediate evidence this is starting to impact pricing but working with an experienced M&A broker will ensure that terms you receive are the best achievable.



In our experience the W&I insurance product has improved significantly in the last few years with insurers increasingly competing not just on cost but also on coverage. It pays to agree the coverage position as much as possible before selecting an insurer.”

Adam Bogdanor Corporate Finance Partner, BLP



W&I insurance is becoming increasingly common, if not standard, on real estate M&A transactions. The W&I market changes quickly though, and you need a broker who can help you navigate through these changes and get the best coverage for your client.”

Tom Watkins, Corporate Real Estate Partner, Linklaters



We are now seeing the use of W&I policies routinely on real estate SPV acquisitions. W&I can offer advantages for both buyers and sellers of single assets and portfolios via SPVs, and can help smooth the process and the extraction of sale proceeds. The market is maturing and a number of insurers have entered the market. Premia and underwriters’ terms are becoming more standardised, and certain tax risks can now also be covered.”

Robert Moir, Head of Corporate Real Estate at Pinsent Masons

²Munich Re report: *Warranty and indemnity insurance: Will euphoria give way to disillusionment?* 09.06.17

JLT provides insurance broking, risk management and claims consulting services to large and international companies. Our success comes from focusing on sectors where we know we can make the greatest difference – using insight, intelligence and imagination to provide expert advice and robust – often unique – solutions. We build partner teams to work side-by-side with you, our network and the market to deliver responses which are carefully considered from all angles.

Our Real Estate division has a wealth of experience, recognised within both the insurance market and real estate sector. The team specialises in the placement and management of real estate focused solutions utilising market leading IT platforms that are web based and allow control of the programme and access to real time information anywhere in the world.

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CLAIMS CASE STUDY

Real Estate Claims Example from Pembroke Managing Agency Limited

Our insured was a UK company who purchased a portfolio of properties which were installed with solar panels.

Subsequent to completion of the deal the purchaser submitted a claim in relation to the breach of numerous seller warranties including:

- Lease obligations
- Solar panels installed as permitted by the leases and
- Obligation to register leases with Land Registry

After a claims investigation, the insurer found that the purchaser had suffered a direct loss as a result of these breaches and made a claims payment of GBP 2.6 million.