Risk in Review 2020–21

Global M&A and Transaction Solutions

Mergermarket
An Acuris company

Aon

Methodology

In Q4 2020, Mergermarket surveyed 50 senior executives from corporate development teams, private equity firms and investment banks. 40% of respondents were based in North America, 30% were based in EMEA and 30% in Asia Pacific. The survey included a combination of qualitative and quantitative questions. Results were analyzed and collated by Mergermarket. All responses are anonymized and presented in aggregate.

Introduction

Few if any dealmakers foresaw the events of 2020. The damage wrought by the abrupt opening and closing of parts of the economy and the human cost of the pandemic has been acutely felt by companies. Investors have had to return to the drawing board to reappraise their strategies and determine the best course of action.

That said, the resilience of the M&A market has been nothing short of remarkable, given the sharp drop-offs in Q1 and Q2 and the continued virulence of COVID-19 and its associated lockdowns. Activity spiked dramatically in Q3 and Q4. Indeed, the final quarter of 2020 saw the highest quarterly global M&A value total for five years. This rebound came about despite the elevated risk outlook and the momentum has carried over into 2021, with US deals hitting record highs in Q1. This suggests that demand for M&A insurance will be high. Deal parties will be looking to protect their downside and improve their liquidity by circumventing the use of escrow accounts.

In our latest survey of senior executives from corporate development teams, private equity firms and investment banks, the results support this expected trend: 88% believe their use of representations & warranties (R&W, also known as warranty & indemnity, or W&I) insurance will increase over the coming 12 months, including 40% who expect it to increase significantly.

Given the immense financial pressure that companies have come under in recent months, the remainder of 2021 and beyond is likely to be characterized by a rise in distressed deals. This should also drive demand for M&A insurance products given the associated risks that come with such deals. Distressed companies face material deterioration of performance. There may also be an unwillingness of vendors in restructuring processes, which may be trustees rather than natural shareholders, to assume litigation or tax risks should problems arise in these higher-risk transactions.

We also see the increasingly critical value placed on intellectual property (IP) rights and the desire to ensure the enforceability of these rights. Whether a prized technology or software or the trademark to other designs, maintaining exclusivity to intangible assets can make or break the success of a deal and the value it delivers for an acquirer. Protecting these assets is paramount and 86% of respondents say they expect their use of IP litigation insurance will increase in 2021.

The overarching trend is that M&A insurance is going mainstream and so whether deal activity continues its recovery trajectory past Q1 2021 or whether it is derailed by further economic disruptions, these policies are becoming an increasingly common feature of any deal.

This report explores investors' M&A expectations for the next 12 months, the sectors they believe will outperform, the strategies employed to mitigate key risks beyond COVID, and how and why the suite of available M&A insurance products are being used.

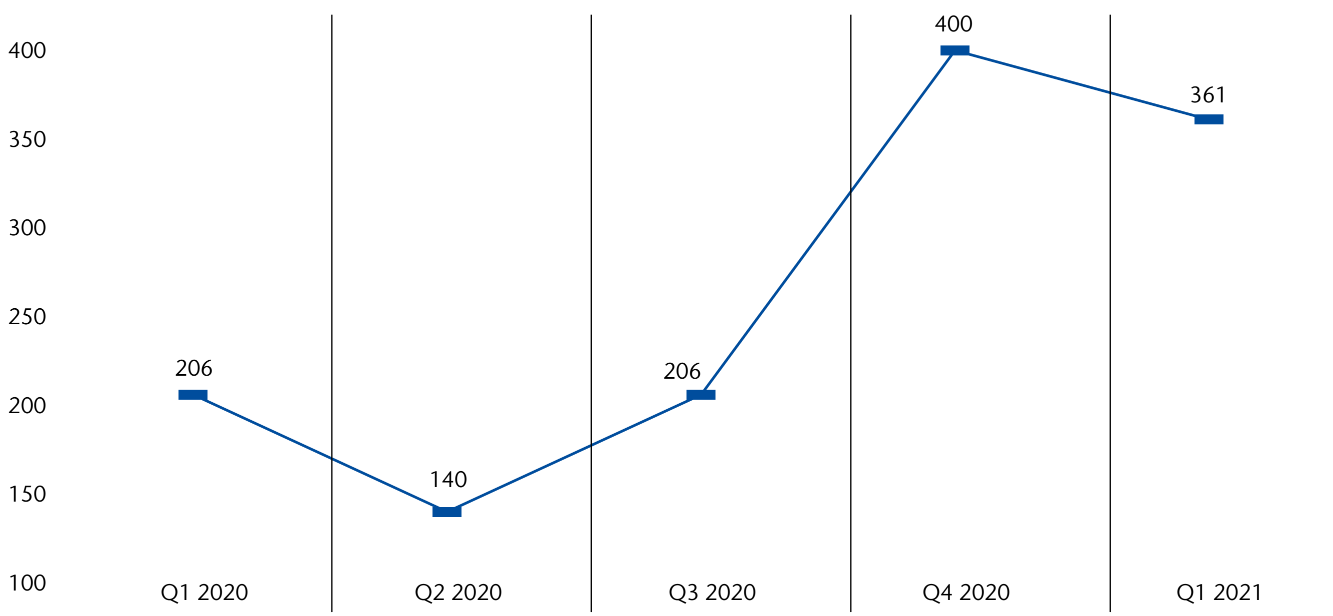
Key takeaways from report:

- When asked about the most prolific sectors in terms of expected M&A activity over the next 12 months, 52% point to Technology, Media & Telecoms (TMT) as one of the top two sectors. In a second place, 36% cite Consumer, 32% say Pharma, Medical & Biotech (PMB), and a further 32% chose Financial Services. (3)

- Globally in 2020, key sectors across the M&A deals for which Aon placed M&A insurance included IT/Tech & Data Analytics & Software as the most active, representing 12% of overall activity (not surprisingly given the Tech industry's ability to weather the COVID storm and provide products and services designed to fuel the reliance on remote work and connectivity) with Professional/Financial/Tech Services a close second at 11%. Asia interestingly saw a stronger showing in Manufacturing deals (27%) which queries whether the earlier onset and ultimate rebound from COVID played a role there. Aon has also seen a significant and increased use of R&W and tax insurance in the renewables industry both with the mergers and acquisition of renewable energy focused companies and in tax equity investing. These solutions have been used as a way to expand the pool of investors in the US solar and wind space.

- In terms of regions, 68% say Asia-Pacific excluding Japan will be among the top two most active regions, while 56% feel the same about North America (56%). (5)
- Critically important sources of funding are expected to include private equity (62% say it will be among the top two sources) and non-bank lenders/credit funds (44%). (7)
- The risk mitigation strategy that most respondents can envisage themselves adopting in the future is pursuing more minority deals/JVs (52% identify it as one of their top two likely steps). Respondents also cite reducing the size of deals (26%) and engaging in more inwardly focused activity (26%). (13)
- Along with use of R&W insurance on traditional buyout transactions, a growing number of minority deals utilized insurance along with other unique applications such as secondary and de-SPAC transactions which proliferated in 2020.
- In North America, average deal size in which R&W insurance was placed went up by 25% in 2020 but median deal size went down by 4%, modest but likely driven by a spate of smaller deals consisting of the deal activity at the early onset of COVID.

Global bound deals by Aon

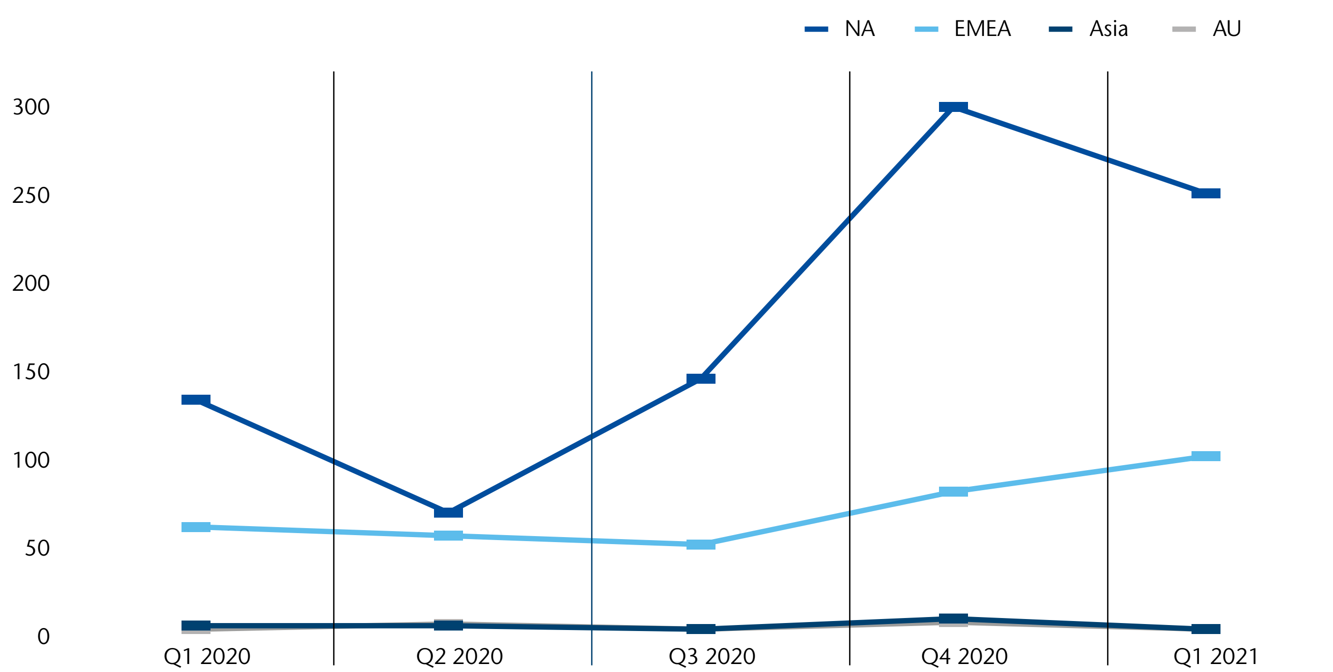


- 96% of respondents say they are dedicating more resources to due diligence because of current economic conditions. (12)

Early on, deal processes were abandoned or put on hold and deal volume evaporated, however more encouraging signs of life were seen in the latter half of Q3 with a strong recovery to “normal” or even above normal deal flow through Q4. Aon’s global Transaction Solutions practice witnessed a sharp uptick in M&A activity as the year unfolded, climbing back and closing the year having placed M&A insurance for 1,069 deals, representing a more modest than expected decline over 2019 of only 12.6%. Despite decline in deal volume, the aggregate limits placed in the M&A insurance market remained on par with 2020 at circa $44 billion, driven by some larger deals closing in the first and fourth quarters as well as a large blockbuster R&W deal in which $1.3 billion in limits was amassed (the largest R&W deal to date). 2020 started off incredibly well for the M&A market, which abruptly came to a halt at the beginning of March due to the increasing COVID-19 restrictions and cases.

As seen on the below graphs, both deals bound and new deals were on the increase through February, but then as the market came to a standstill so did the deal flow. With about three months of stagnation, the market adjusted to the new normal and with that, deals that were put on hold and new submissions began to slowly increase again. Even though the numbers for Q1 and Q2 were far behind expectations, the rebound in Q3 and Q4 was more than anyone could have predicted. For new opportunities, the combined deals in Q3 and Q4 increased by 68% compared to the beginning half of the year. Whereas bound deals in the latter half of the year surpassed the total bound deals from the beginning of 2020 by about 119%.

Region deals by Aon

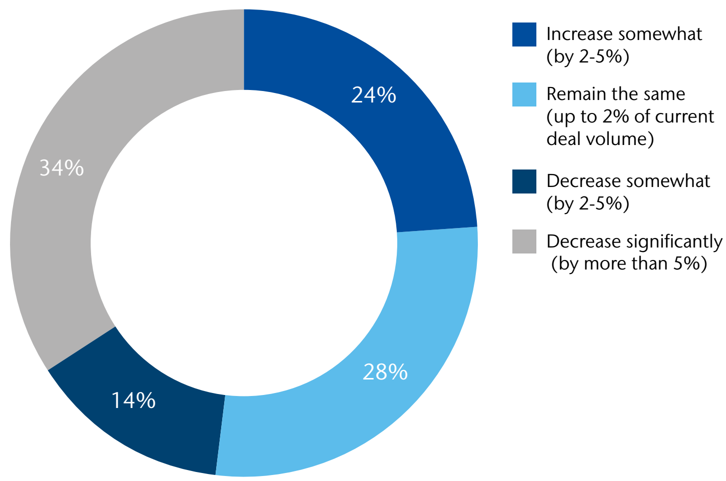


Part 1: **Market momentum or delayed deals? M&A in 2021**

Global M&A activity was brought to a near standstill in Q2 2020 after a decade of exceptional growth. Soon after the coronavirus outbreak was deemed to be a global pandemic, financial sponsors and strategic acquirers refrained from participating in the deal market as they reassessed the risk environment and their strategies. This resulted in the lowest quarterly performance in a second quarter for more than a decade. The US$372 billion in transactions represented a year-on-year decline of 62%. However, with the easing of lockdown measures came a sharp rebound in completed deal flow in the third quarter and this recovery carrying over into Q4.

With the most turbulent year in recent memory at an end, our survey reveals that investors are divided on their expectations for 2021. Over half (52%) believe that dealmaking will stay at similar levels or increase. However, the remainder feel that the number of M&A deals globally will decrease over the next 12 months, including 34% who think it will decrease by more than 5% compared to the previous 12 months. (Question 1).

1. What do you think will happen to the number of M&A deals globally over the coming 12 months? (Select one)



Ups and downs in dealmaking

There is no shortage of reasons to be optimistic about the months ahead. Swift progress has been made in 2021, with the mass roll-out of vaccinations quelling the rising pandemic in the US. If successful, this should prompt a return of economic activity in cyclical industries and those most exposed to the effects of the pandemic, such as energy, industrials, travel, leisure and the discretionary consumer goods sectors. A spike in household savings rates in 2020 also bodes well for a return of pent-up consumption.

After months of challenging trading and with the unwinding of government support, market dynamics should support opportunistic M&A strategies in a distressed deal environment. Well-capitalized corporates have an opportunity to make selective strategic acquisitions at attractive prices. Private equity (PE) continues to wield immense firepower, with an estimated US$1.7 trillion in uncalled capital as at July 2020. Indeed, 40% of respondents in our research say they expect increased PE activity during the ongoing COVID-19 pandemic, making it a defining trend in the eyes of investors. (2)

On the other hand, investors need to proceed with caution. The macroeconomic outlook is far from certain and this may challenge deal processes, as buyers and sellers struggle to find common ground. Such uncertainty calls for robust due diligence to test and reinforce investment theses, a process made more difficult by distancing measures and reduced travel. The simple fact that target companies' operational bandwidth is taken up navigating the challenges of today's environment can make due diligence more burdensome than usual. Risk aversion is likely to remain high in 2021 and this has the potential to result in deals lapsing, especially if circumstances and trading conditions meaningfully change. The second most anticipated trend amid the ongoing pandemic, cited by 36% of respondents, is more lapsed deals.

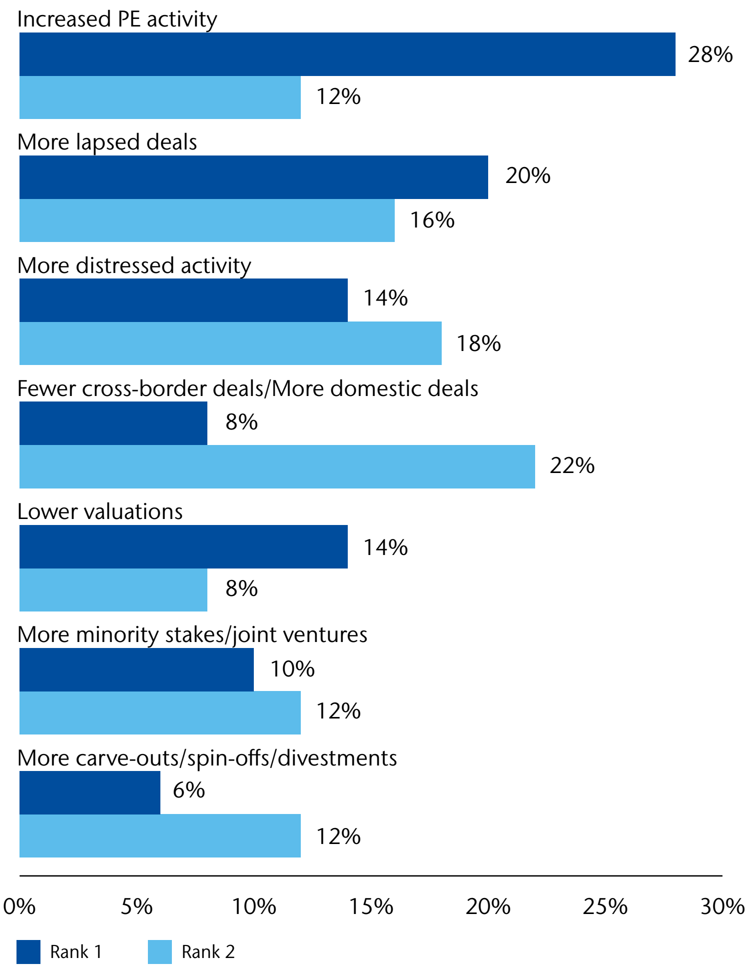
Identifying opportunities: Sectors

There have been clear winners and losers in the last year, with sectoral lines more pronounced than ever. This has not only manifested in a bifurcated stock market, with big tech and the wider software and technology industry outperforming all others, but also in M&A activity. Globally, there was US$512.6 billion worth of TMT deals in the first nine months of 2020, accounting for 27.5% of deal value. It was also the highest volume sector, with 2,512 transactions or 22.4% of all deals.

TMT has been a strong M&A performer in recent years but extended its lead in 2020. Amid distancing measures and homeworking, companies delivering digital services that added value and facilitated economic activity boomed. Investors are confident that these fundamentals will remain in place, with 52% of respondents expecting TMT to be one of the most prolific sectors for M&A activity over the next 12 months. This is followed by Consumer (36%), Pharma, Medical & Biotech (PMB) and Financial Services (32%). (3)

Conversely, 46% believe the Energy, Mining & Utilities (EMU) sector will be the least productive in terms of M&A activity. Two successive oil price collapses in 2018 and 2020 have set the EMU industry back significantly and this is likely to depress activity, except among corporates with a strategic imperative to transact or PE sector specialists seeking to capitalize on the market dislocation. In 2020 deals such as Abu Dhabi Power Corporation's US$20.3 billion acquisition of Abu Dhabi National Energy made EMU the second highest value M&A sector, with US$280.5 billion worth of activity. However, on a volume basis the sector claimed just 7.3% of deals

2. What trends do you expect to see in M&A during the ongoing COVID-19 pandemic? (Select top two and rank 1-2)



and the deal flow that did materialize was strongly motivated by fossil fuel companies' pivot to cleaner energy sources as part of the energy transition, a long-term and ongoing trend.

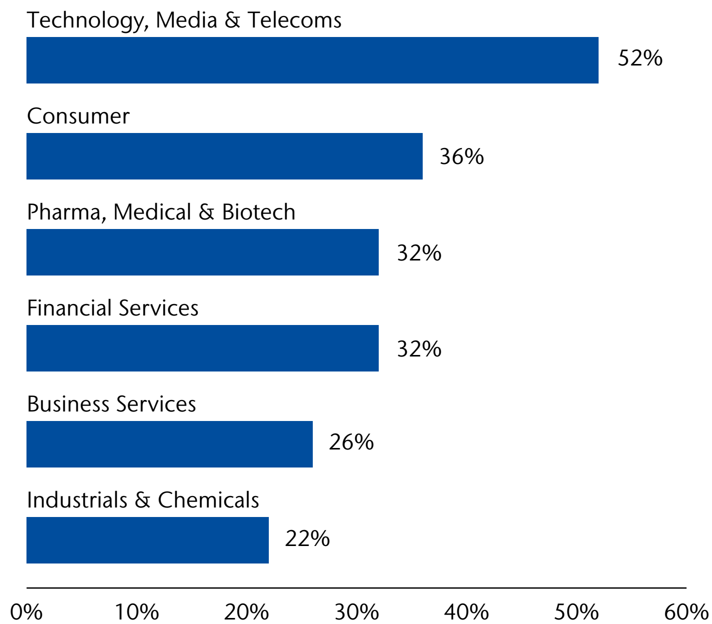
Nearly one-third (30%) of respondents also believe that the Real Estate and Construction sectors will deliver the least M&A activity. Both faced strong headwinds in 2020. The retrenchment of the workforce significantly reduced demand for office space, buffeting the commercial Real Estate sector. The true impact of this may only begin to be felt in 2021 as leases expire and businesses decide whether to renew their existing arrangements.

Identifying opportunities: Regions

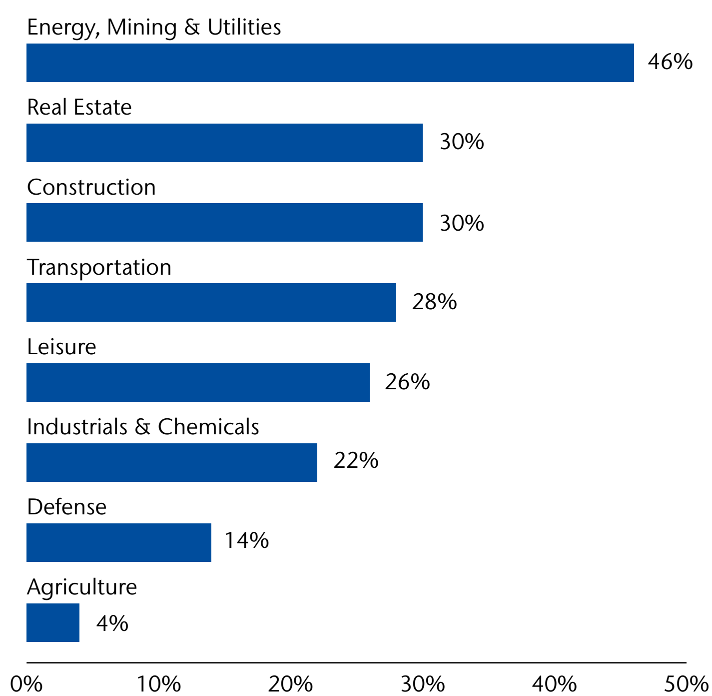
From a geographic perspective, Asia-Pacific (excluding Japan) is viewed by 68% of respondents as being the most attractive region for deals over the next 12 months, followed by 56% who have a preference for North America. China is the only major economy that is forecast to show positive growth in 2020 having swiftly contained the COVID-19 pandemic, while a number of South-East Asian countries are on course to show huge growth over the long term. The US has enduring characteristics as the world's largest economy and biggest M&A market. In a distant third place is Europe, with 32% of respondents earmarking it as the most attractive region for doing deals in 2021. (5)

One factor deterring investors from Europe is the recently hawkish position on foreign direct investment (FDI). Following the lead of the US in its regulatory scrutiny of Chinese investment in strategic sectors, the pandemic has heightened protectionism in the EU. In October 2020, the EU introduced a new FDI Regulation that, rather than establishing a standalone mechanism for vetting foreign investments, as per the US Committee on Foreign Investment in the United States, introduces minimum standards for member states' investment review systems. The regime has also created an information sharing channel between the EU Commission and member states to allow communication and feedback on FDI.

3. Which of the following sectors do you believe will be the most prolific in terms of M&A activity over the next 12 months compared to a year ago? (Select top two)

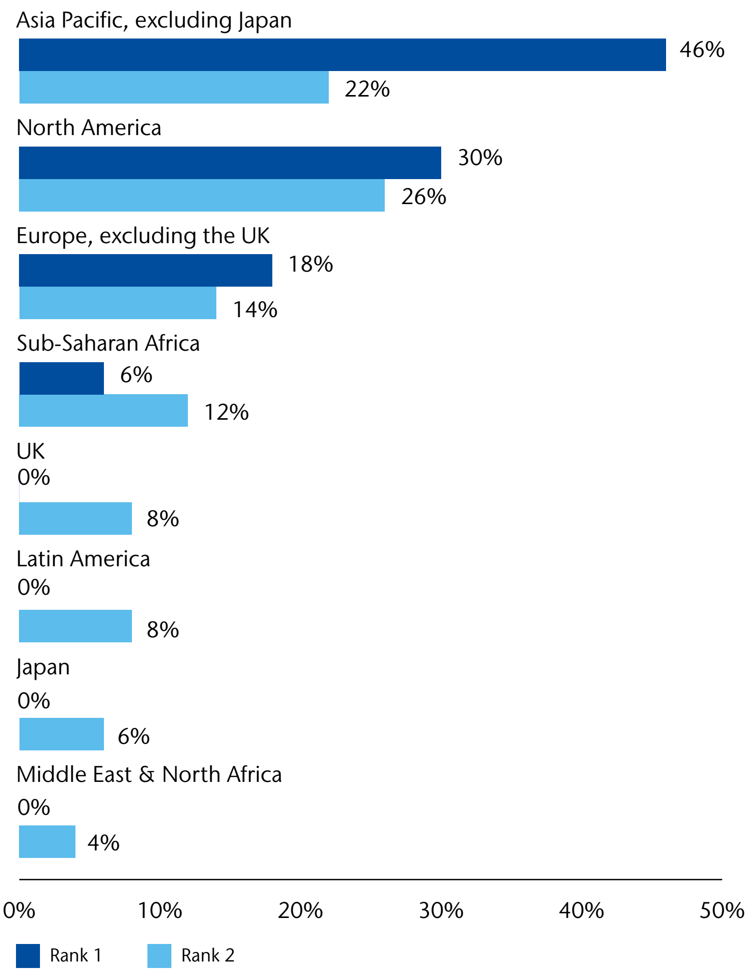


4. Which of the following sectors do you believe will be the least productive? (Select top two)



"Expanding businesses and acquiring assets is easier in the Asia-Pacific region. Although there are strict rules about purchase of property by foreign companies, strategic mergers provide effective solutions for faster development."

5. Which of the following regions do you believe will be the most attractive for M&A over the next 12 months? (Select two and rank 1-2, where 1 is the most attractive and 2 the next most attractive)



These cross-border considerations were voiced by respondents in our research, such as the head of a corporate development team in the US, who said: "Asia-Pacific will stand out because their policies are more open to foreign investors and cross-border trading. Antitrust rulings in Europe have increased complications, so investors are looking for alternative regions in which to expand."

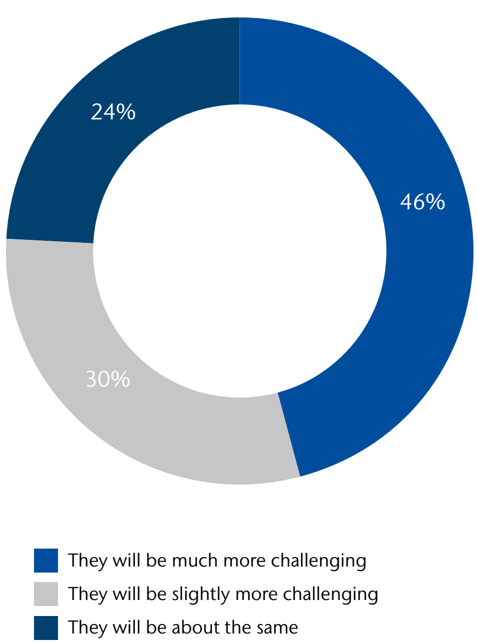
This view is shared by the managing director of an investment bank in Japan, who concurred that: "Expanding businesses and acquiring assets is easier in the Asia-Pacific region. Although there are strict rules about purchase of property by foreign companies, strategic mergers provide effective solutions for faster development."

Financing prospects

The pre-pandemic financing environment already seems like a lifetime ago. For 2021, it is not wholly surprising to find that more than three-quarters of respondents (76%) expect financing conditions over the next 12 months to be more challenging than they were in 2019, including 46% who expect them to be much more challenging. (6)

It goes without saying that the pandemic has altered investors' risk calculations, making them more selective in what sectors and companies they are willing to back – and at what price. But financing prospects are looking up. After a punishing first half to 2020, equity and debt financing has eased in 2021 so far on the back of some positive news. The vaccine rollout has proved effective – increasing investor confidence and pointing to a brighter outlook for companies and their financing needs.

6. How do you expect financing conditions over the next 12 months to compare to conditions in 2019? (Select one)

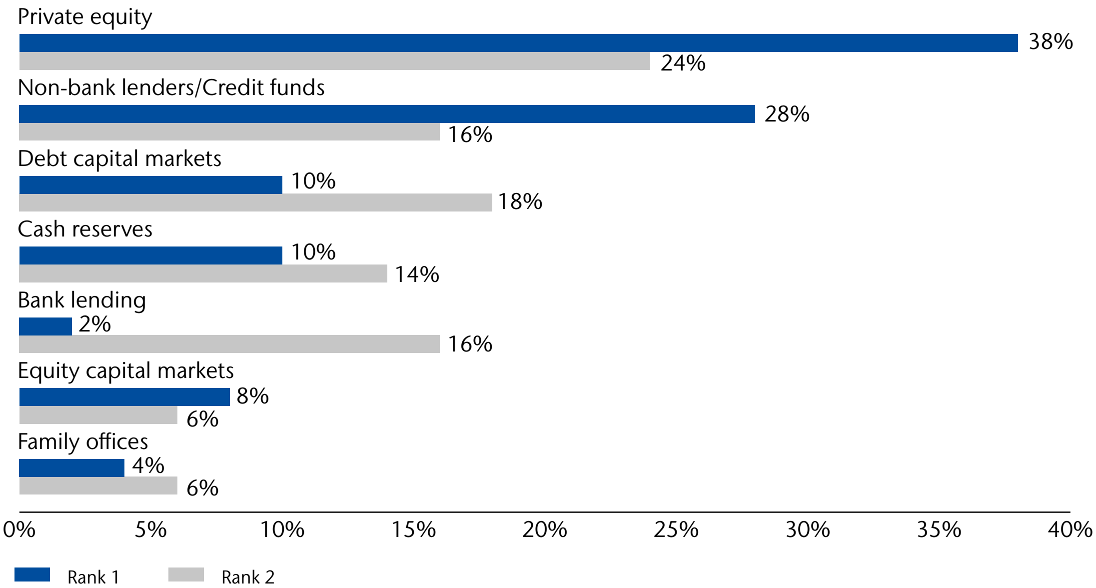


In terms of sources of capital, 62% of respondents view PE and 44% consider non-bank lenders as the primary candidates, over debt capital markets, traditional bank lenders and cash reserves. (7).

These private sources of capital are closely related, increasingly working in tandem. In the past, PE funds either tapped syndicated leveraged loan or high-yield bond markets, both of which are dependent on broad demand for higher-risk debt. One of the main attractions of private debt funds, which specialize in acquiring leveraged loans guaranteed by equity funds, is dealing with a single creditor.

This in turn confers its own advantages, such as the ability to squeeze more leverage into a deal than the market may be willing to accept. Since there are fewer moving parts in PE deals with direct lending arrangements - minimizing transaction closure risk - these arrangements are well suited to what remains an uncertain if improving deal environment.

7. What do you believe will emerge as the primary sources of financing over the next 12 months? (Select top two and rank 1-2, where 1 is the foremost source of financing and 2 the next most available)



Part 2: **Risks and risk mitigation**

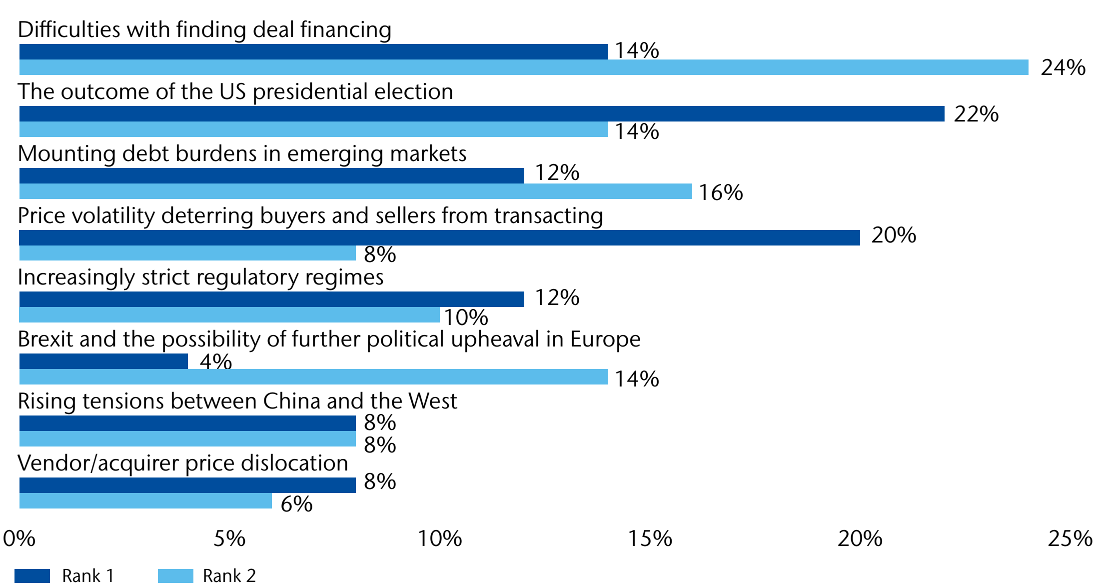
The risk landscape did not just shift in 2020, it was turned on its head. Naturally, the ongoing health crisis looms large in the minds of investors. However, putting the COVID-19 pandemic to one side, there are numerous other downside variables to consider that have the potential to impact upon dealmakers and the M&A targets they are seeking out.

Difficulty in accessing deal financing is the primary concern, cited by 38% of respondents as among the top two impediments standing in their way. (9) The debt financing outlook has since shown signs of improvement, buoyed by the vaccination program. The vaccine roll-out is encouraging a return to some semblance of normal economic activity. This, in turn, has improved trading conditions and the ability of companies in more precarious sectors to repay their debts.

From the perspective of risks that impact deal targets specifically, 52% of respondents say macroeconomic factors are among the top two risks over the coming 12 months. While 2020 drew to a close with some welcome developments and forecasts point to a rebound over the course of this year, the International Monetary Fund predicting 5.2% growth, this is far from guaranteed. (10)

It is not only economic risk that concerns investors. More than a third (36%) of respondents cite tax as a one of two major risks affecting M&A targets. Once again, Biden taking office has implications here. One of the biggest changes made under Trump's Tax Cuts and Jobs Act was the slashing of corporation tax from 35% to 21%. Under Biden's proposed tax plan, the rate would be increased to the midway point of 28%, which would limit companies' profitability.

9. Apart from the ongoing COVID-19 crisis, what do you think will be the two greatest impediments/ sources of risk for dealmakers over the next 12 months? (Select top two and rank 1-2, where 1 is the greatest impediment and 2 the next greatest)



Risk adjustments

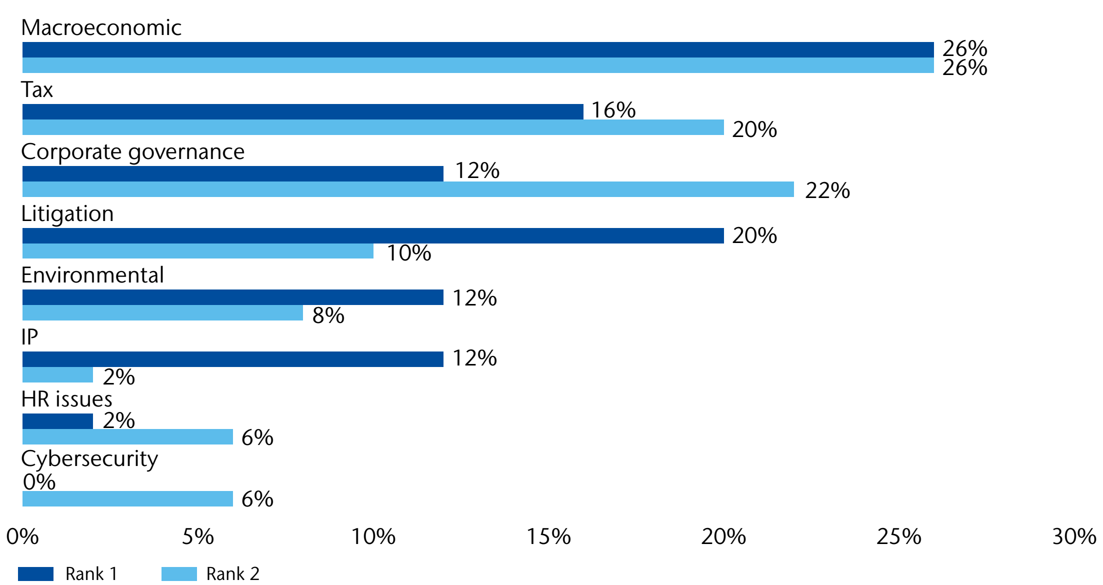
Given the heightened risk environment of 2020, investors have had to think smart and readjust their M&A strategies. This may include doubling down on a core strategic focus or simply sitting on the sidelines altogether until a clearer path forward emerges. The top risk mitigation strategies cited by respondents in our research, however, have been to participate in more minority deals and joint ventures (JVs) and reduce the size of their deals - both approaches cited by 34% of those surveyed. (11)

Taking minority positions can increase risk if investors forgo certain powers, although this can be resolved with the inclusion of supermajority voting rights, pre-emptive rights, tag-along rights and other powers to protect their investment. At the same time, putting down a smaller equity outlay in a minority stake or simply a majority stake in a smaller company can help to minimize capital risk if the business does not perform as expected.

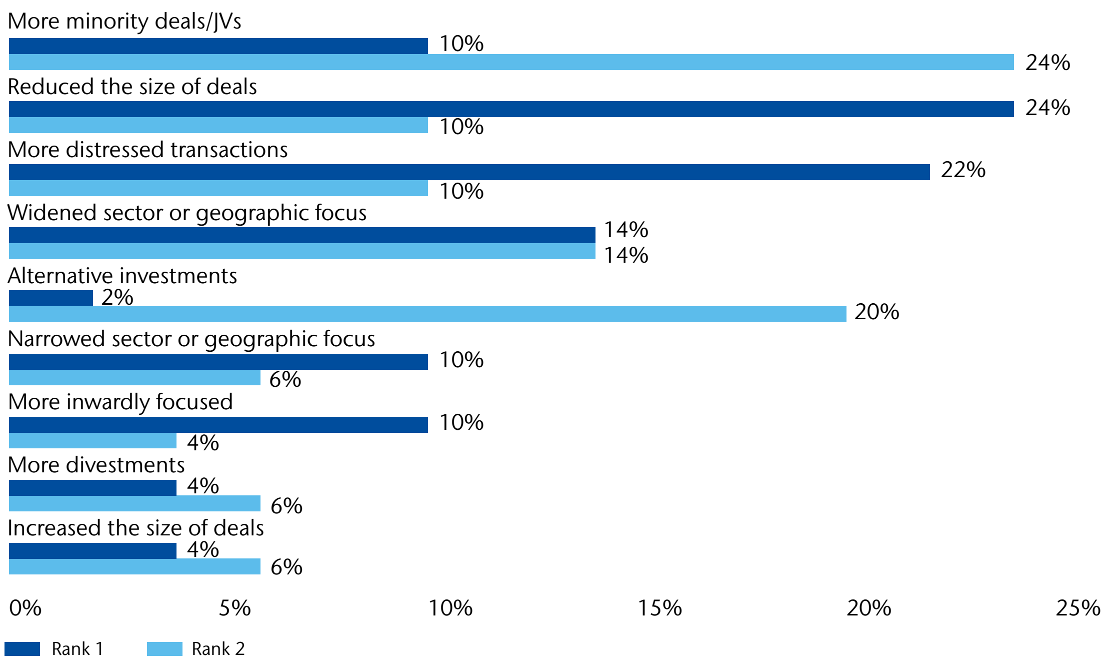
A similar proportion of investors (32%) also say they have adopted distressed strategies in 2020, which aligns with the deal environment. Government intervention to prop up economies through bond and loan buying programs has bought additional time for many companies. However, as these programs unwind, more distressed opportunities are likely to come to market.

Investors will be paying close attention to the performance of businesses and many will be taking pre-emptive action by proactively starting dialogue with these companies and their primary lenders, rather than waiting until the last minute for them to topple over.

10. What are the biggest risks you foresee at potential M&A targets over the coming 12 months? (Select top two and rank 1-2)



11. What steps have you taken to change your M&A strategy since the start of 2020? (Select top two and rank 1-2)



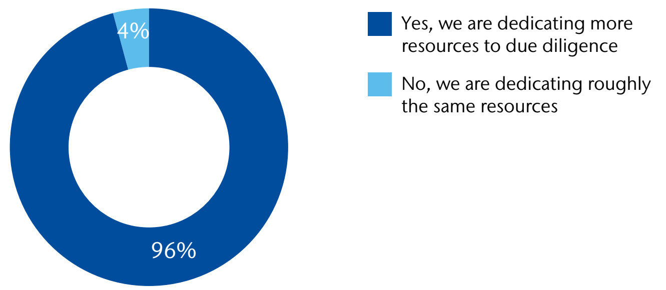
The risk mitigation strategy that most respondents foresee adopting in the future is pursuing more minority deals/JVs, 52% identifying this as one of their top two likely courses of action. There besides, respondents also cite reducing the size of deals (26%) and engaging in more inwardly focused activity (26%). (13)

Due diligence – an even higher priority

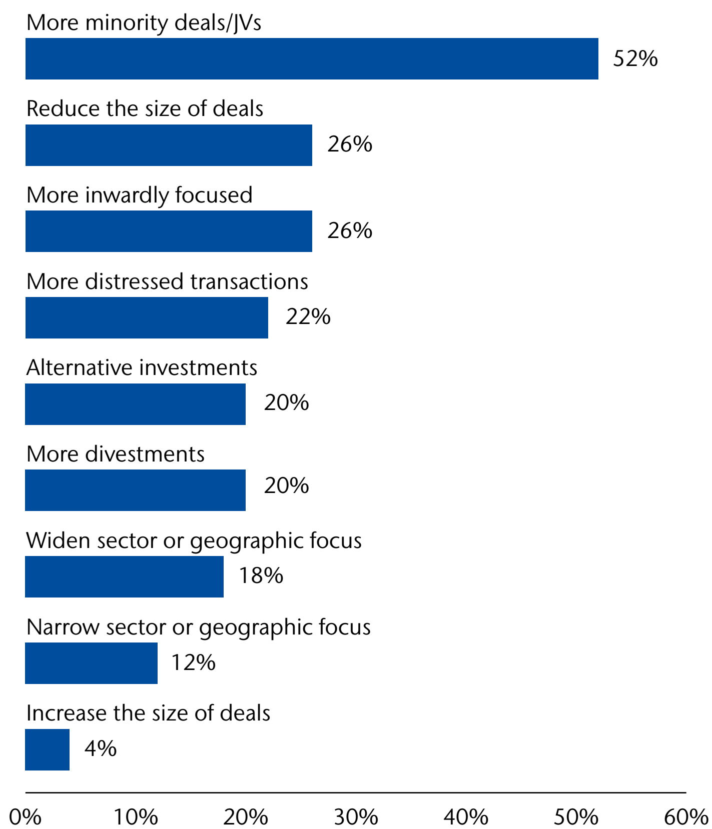
Due diligence is a critical component of any deal. In times of economic stress and uncertainty, however, deeper, more rigorous diligence is often warranted to triple test assumptions and ensure the fundamentals of the target business are as advertised. An overwhelming majority (96%) of respondents say they are dedicating more resources to due diligence because of current economic conditions. (12) Understanding the likely performance of a given sector or sub-sector is as important as determining the company's performance within that space. The managing director of a Chinese PE firm says that balancing this outward-looking perspective with a thorough look at the business can help avoid legal issues. "Adequate due diligence preparation is essential to mitigate any litigation risk. Not just the target's performance, but the external factors and geopolitical risks should also be measured appropriately."

The COVID-19 pandemic has clearly made dealmaking more challenging, not least because negotiations have to be conducted remotely as people continue to avoid all but absolutely necessary travel. Technology has played a major role in helping acquirers understand the inner workings of target companies. Tools such as sophisticated virtual data rooms and the application of advanced data analytics have minimized disruption to M&A, allowing in-depth, incisive due diligence and negotiations to be undertaken at arm's length. "Use of new technology for assessing the risks is one practical way to mitigate them. Technology solutions complement the risk management principles of the organization and provide useful data to support decisions," says the managing director of a UK investment bank.

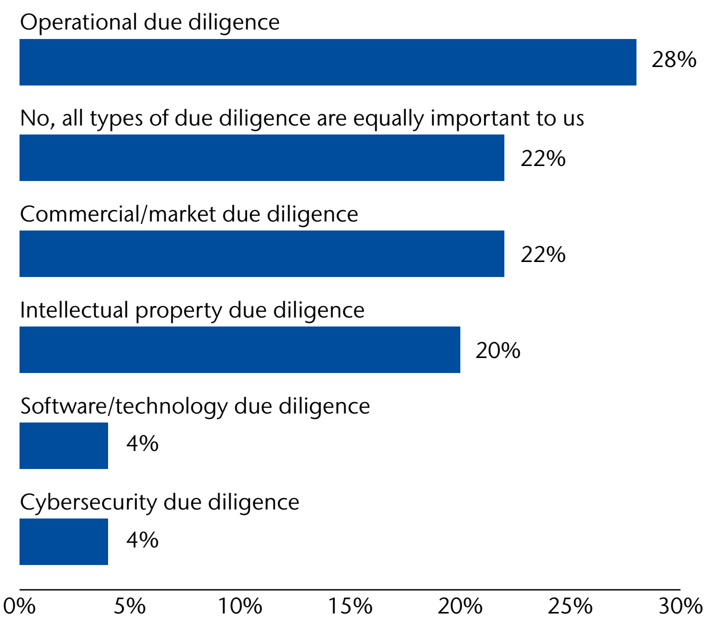
12. Considering the current economic environment, are you dedicating more resources than in the past to due diligence processes when considering a transaction? (Select one)



13. What steps do you envisage taking in the future? (Select top two)



14) Are you paying particularly close attention to any of the following types of due diligence? (Select one)



Diligence comes in various forms and our research indicates no one type takes absolute priority. For instance, we find that while 28% of investors are paying particularly close attention to operational due diligence, putting it ahead of all others, commercial/market due diligence (22%) and IP due diligence (20%) are not far behind. Meanwhile, 22% of respondents did not specify and say all types of due diligence are equally important to them. (14)

From our own work, we are seeing an increasing focus on IP diligence among clients. This involves assessing the integrity of claims to ownership of intellectual property critical to the success of the company that is up for sale. Buyers need comfort that a third party does not have a legitimate claim to the IP and that all disclosures about those assets have been made in good faith. Deeper audits may check the enforceability of patents and whether there is any history of litigation or undisclosed information that relate to patents on the IP.

28% of investors are paying particularly close attention to operational due diligence, putting it ahead of all other types of due diligence

COVID Credit Risk

The COVID-19 pandemic has unquestionably impacted companies' credit risk. For one, businesses within sectors hit by the crisis, namely industries that rely on physical interaction and face-to-face working, have seen their revenues collapse in 2020 amid lockdown measures and the economic downturn. Weaker turnover and earnings in turn inhibit the ability of a company to repay its existing liabilities, increasing credit risk.

Another factor is market access. Sturdy credits in industries such as technology and non-discretionary retail, which have demonstrated extreme resilience to the effects of the pandemic, are highly sought after among lending institutions and bond investors and should not have trouble tapping markets to raise cash. This is especially true given that interest rates around the world have been cut back to or near zero, making investors hungry for yield.

However, highly exposed companies will have to pay high coupons in order to access debt, especially in high-risk periods if the pandemic continues to wax and wane. "Dealing with credit risk will be challenging because financing opportunities are also limited. To ensure that operations are functioning at par with expectations, capital investments are required. If this is not possible, it will affect goals," says the managing director of an investment bank in Canada.

The unpredictable nature of the pandemic and its downstream effects on companies and their suppliers also make credit risk open to a greater degree of interpretation, says the managing director of an investment bank in Australia. "Terms of the agreement and warranty discussions are taking longer to formulate. Credit risk will also depend on perception, as we see in the case of varied opinions during valuation discussions between buyers and sellers."

The speed and severity with which the pandemic has buffeted companies has only increased the subjectivity of credit risk calculations, an observation made by numerous respondents in our research. For instance, the group director of M&A at a French corporate says that "because Covid-19 has been a massive shock to operations, relying on the company's most recent financial data is of limited help in judging credit risk". Meanwhile, a partner at a US private equity firm tells us that "it is vital to evaluate the external climate and its effects on the target, without discounting the company's actual potential".

Part 3: **Focus on litigation and tax risks**

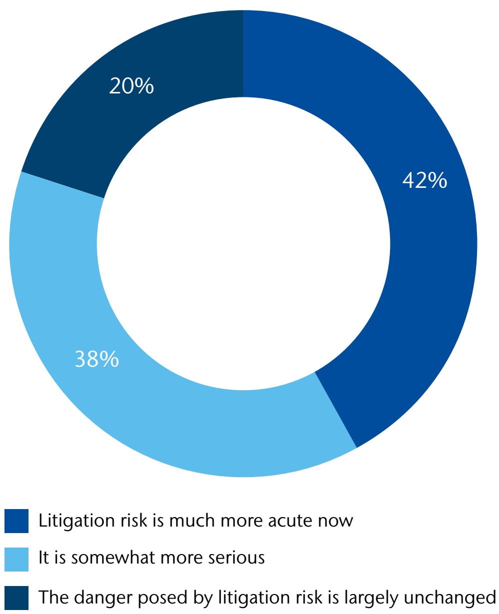
The business disruptions caused by the COVID-19 pandemic have elevated risk to investors pursuing M&A. The unpredictability of the external trading environment and its potential impact on a deal target's employees, key vendors and customers places priority not only on deeper due diligence but also taking out R&W insurance. This is one of the most important risk management tools at investors' disposal in this environment. Any potential breach of warranties can result in material litigation costs as acquirers seek to recover value.

Investors are highly aware of heightened litigation risk in M&A situations in the wake of the coronavirus pandemic. A large majority (80%) say litigation risk is more acute now than in the recent past — this includes 42% who say it is much more acute now. (15) The sheer breadth of litigation risks can be overwhelming, however some of these are long established and acquirers will be familiar with these potential risk hotspots. Others are newer and less familiar.

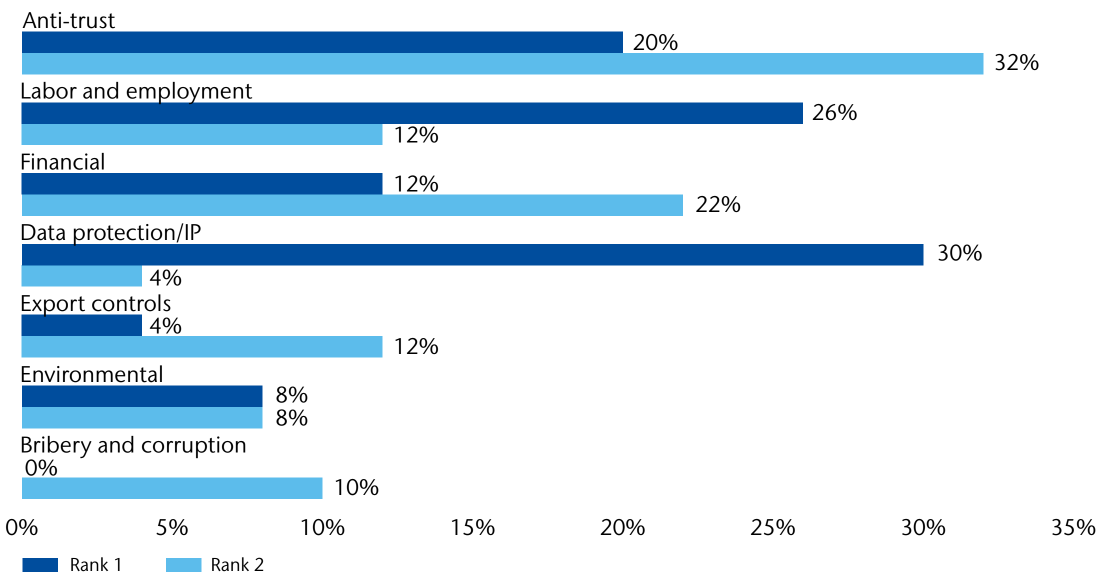
Litigation risk 1: Antitrust

In our research we see that investors are primarily concerned with litigation connected to data protection/IP antitrust issues, 30% of those surveyed highlighting this as their number one concern. This can be a complex area to navigate. IP rights are essentially monopoly rights awarded by regulators that defend a company's goods and services from competition. There is a balance to be struck by governments to afford companies these rights with the need to ensure that companies do not abuse their dominant market position and that markets are competitive for the benefit of clients and consumers. As an acquirer, you want to know that a target company possesses IP that puts it at a significant competitive advantage, without it being exposed to excessive risk of antitrust action.

15. How much more acute is the risk of litigation to deal success now as compared to the recent past? (Select one)



16. What type of litigation creates the most concern in a deal? (Select top two and rank 1-2)



Litgation risk 2: Labor laws

More than a quarter (26%) of respondents also point to labor and employment and 20% highlight conventional antitrust as areas of litigation that are of most concern. (16) Employment lawsuits may arise as a result of any number of claims relating to discrimination, harassment, pay, overtime or scheduling. With many companies under financial and operational stress in today's environment, the potential for such issues to arise has increased. It is therefore important that investors pay close attention to what exactly their R&W insurance covers regarding labor representations and, if relevant, the target company's IP.

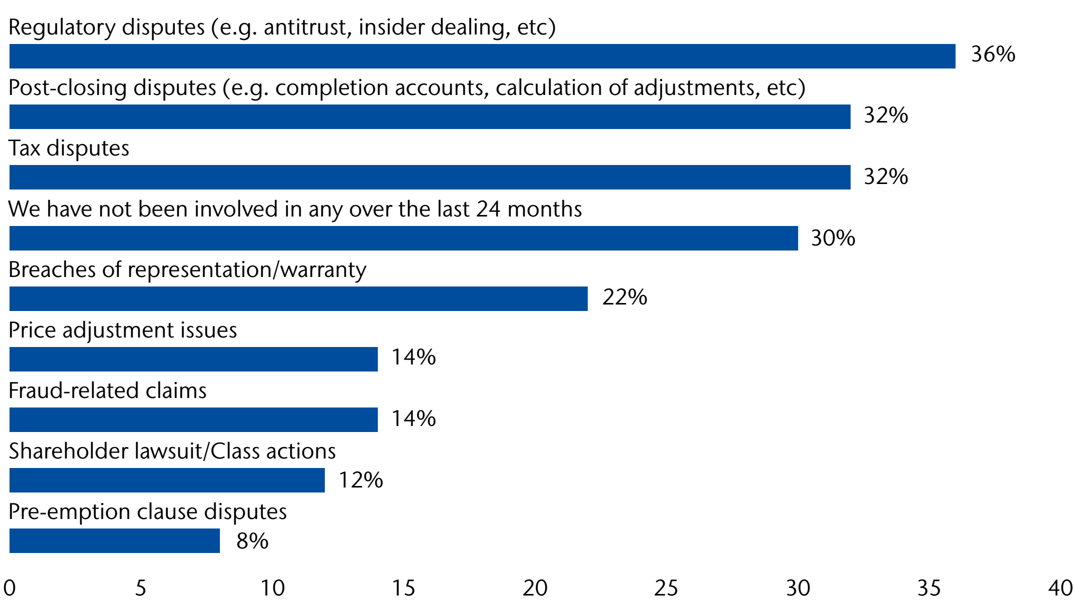
86% of respondents expect to increase the use of IP litigation insurance over the next 12 months, including 58% who expect its use to rise significantly

Regulatory headaches

Over the past year, meanwhile, 36% of interviewees have been involved in regulatory disputes relating to M&A, with 32% having had post-closing disputes and another 32% having been involved in tax disputes. (17) While insurance is a valuable and necessary risk management mechanism, prevention is ultimately better than cure. As the head of M&A in the US says, while insurance covers costs and legal expenses should litigation arise: "We prefer emphasis on following the prescribed due diligence standards and timelines given the reputational damage that can be caused should a legal case be brought."

This starts by front loading deal sourcing with due diligence and, with careful selection, avoiding deal targets that have had significant past legal disputes.

17. What types of M&A litigation has your organization been involved in over the last 24 months? (Select all that apply)



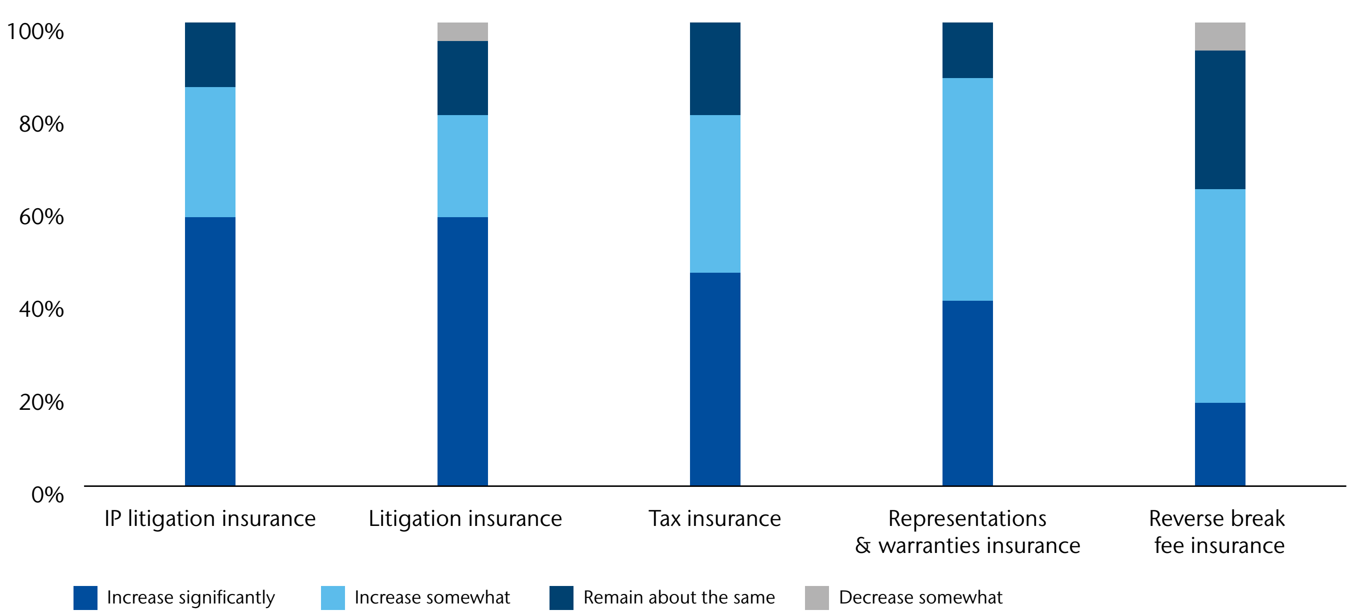
This is a strategy espoused by a head of M&A in Germany who says that: "Sourcing and research teams are crucial in mitigating the litigation risks early on. Selecting the pool of targets and collecting background information is crucial to the process."

A US director of corporate development echoes the importance of background checks in mitigating litigation risk, saying: "Previous IP, property or employee disputes are analyzed to identify any potential threats. This provides us enough information to decide on whether the parties are being straightforward with their disclosures."

Given intermittent restrictions on travel, dedicating extra resource at the diligence stage may require additional outsourcing, especially in cross-border transactions. "In the current scenario, there are additional risks that could be revealed after we've started the transaction essentials," says the managing partner of a Dutch PE firm. "As travel has been restricted to some extent, sourcing and due diligence is being managed in consultation with local experts."

However deep diligence processes go, insurance will always be used as a last line of defense to protect acquirers in the event of a worst-case scenario materializing. Reflecting growing concern among investors about IP risks, 86% of respondents expect to increase the use of IP litigation insurance over the next 12 months, including 58% who expect its use to rise significantly. This is followed by general litigation insurance (80%, including 58% who expect to significantly increase) and tax insurance (also 80%, including 46% who anticipate significantly increasing). (18)

18. What do you expect to happen to your use of the following insurance solutions over the coming 12 months? (Select one for each insurance solution)



Tax risk

The vast majority (80%) of respondents say that tax risk is a more serious threat to deal success now than it was in the recent past, including 46% who say the risk is now much more acute. (19) There are a couple of factors at play here. Unprecedented worldwide stimulus support in 2020 has dramatically inflated public debt and governments are now determining how to pay this down by adjusting their tax collection regimes.

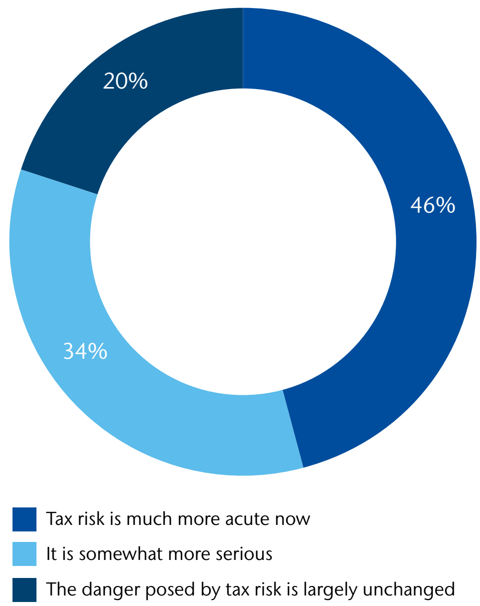
A further consideration is the change in the US administration that took place towards the end of 2020. It is expected that the new administration will review and raise taxes where it deems it appropriate, a development that is highly pertinent given America's position as the largest national M&A market globally.

A forward-looking perspective is therefore vital. "Assessing the tax attributes of the target company is important. We try and gauge potential risks that may evolve after the transaction has been completed as well. This provides an all-round view of the deal situation," says an M&A director in Malaysia.

This need for foresight and looking beyond the current taxation conditions in a given territory is also emphasized by a US director of strategy and corporate development, who says that: "Getting a general idea about the taxation norms in any region is not enough. We have to delve into additional details that are relevant to the industry and uncover discrepancies in the information provided in good time. Use of technology has been vital to streamlining this process and mitigating risks."

Among tax-related anxieties, the greatest concerns identified in our research include increased rates (34%) and a proliferation of anti-abuse rules (26%), the latter being consistent with the Organisation for Economic Co-operation and Development in recent years seeking to coordinate government efforts in tackling base erosion and profit shifting. (20) These macro tax concerns add to tax uncertainty complying with legislative initiatives, such as the U.S. BEAT tax, coupled with generally existing tax uncertainty

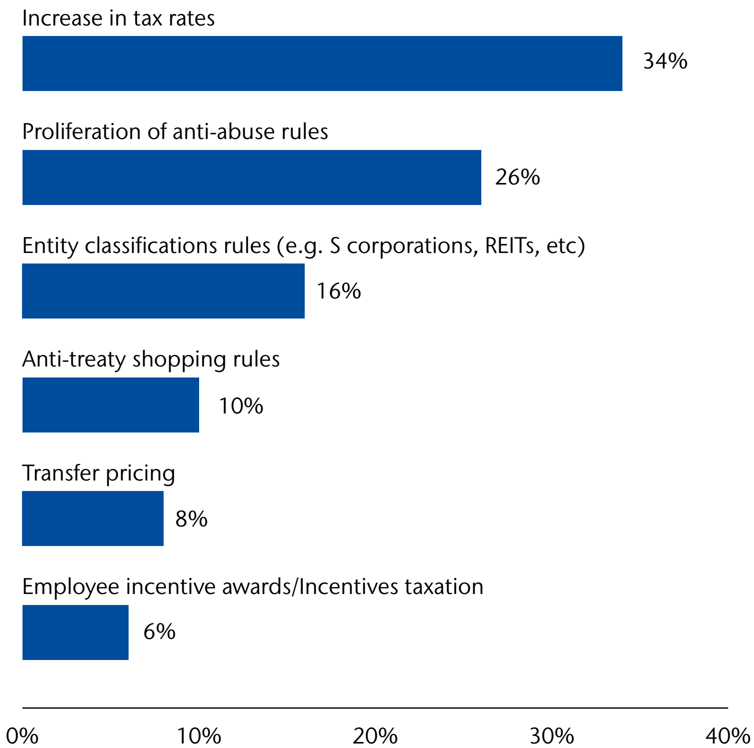
19. How much more acute is tax risk to deal success now as compared to the recent past? (Select one)



which is inherent in M&A when an acquirer steps into the target company's tax exposures and open tax years.

Unlike other risks that may be more visible, tax risk can be harder to predict since it is at the whim of political policy or other unforeseen circumstances. However, in the context of M&A, tax uncertainty is present as a matter of the acquired company's pre-exiting tax positions and the limitations of the acquirer's diligence process. Tax insurance absolves this by transferring this unpredictable risk away from both parties and, like R&W insurance, means vendors can avoid holding capital in escrow, therefore improving their liquidity. For 2021, there is likely to be an increasing volume of distressed deal flow as balance sheets succumb to the financial pressure caused by lockdowns and weakened economic activity. Distressed deals and restructurings are likely to increase demand for tax insurance, especially among administrators, trustees and insolvency practitioners who may be unwilling or unable to provide tax or other warranties.

20. Which of the following tax-related issues is of the greatest concern to you? (Select one)



Conclusion: **Four key trends for the year ahead**

The year 2020 has been a defining moment for M&A markets, bookending a decade-plus run. Over this period, there has been a steady uptake in R&W cover and other M&A insurance policies. Despite market challenges, deal activity has demonstrated resilience and, so far, record deal figures have been recorded in 2021. This is expected to result in higher relative levels of insurance as investors continue to grow accustomed to this vital risk mitigation and capital efficiency tool. For their part, insurers are innovating policies and finding new approaches to protect against risks on the behalf of investors.

With the findings of this report in mind, here are some related trends that we can expect to see emerge in the year ahead.

The value of technology and technology-enablement

Investors anticipate TMT being a dominant M&A sector as it has been in 2020. The key fundamentals of high potential for scalability, relatively low capital expenditure requirements and services that enable the continuation of business activity make assets in the industry highly sought after. This will naturally result in high entry prices for prized businesses, which in turn will necessitate rock solid investment theses to justify such prices.

Deeper due diligence

Due diligence will have to go deeper than ever to determine whether to pay a premium to secure an in-demand business or secure a deal in an overlooked or distressed niche of the economy. Investors will benefit from initiating diligence early in their deal sourcing processes to weed out companies with insurmountable red flags. When credible investment propositions have been identified, investors will employ a wider range of due diligence to fully test deal targets and assumptions. A key to maximizing value will be implementation of recommendations and solutions identified in diligence and quick integration of add-on acquisitions.

Risk mitigation through R&W insurance

While R&W policies are now more common than ever, the unpredictability and higher-risk nature of the trading environment should increase demand for such policies in 2021. Not only will this help investors to protect their downside risk, but it will also enable them to unlock much needed liquidity by avoiding having capital trapped in escrow.

IP diligence and insurance to increase with TMT activity

IP is fundamental to technology and tech-related companies and, given that TMT deals are expected to outperform, we should also see investors pour more resources into IP due diligence than ever before. The same applies to M&A insurance policies that cover IP litigation to protect against any claims made against target companies and their rights to these intangible yet highly valuable properties.

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Mergermarket is an independent mergers & acquisitions (M&A) proprietary intelligence tool. Mergermarket provides a complete overview of the M&A market by offering both a forward-looking intelligence database and a historical deals database, achieving real revenues for Mergermarket clients.

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