Hogan Lovells

UK insurance M&A following COVID-19

18 June 2020

We are living in volatile times. As a consequence of the COVID-19 virus, our equity and high-yield markets have witnessed large swings, making it difficult to value assets. Uncertainty over the timing and extent of the recovery has also made it difficult to value income streams. Moreover, debt financing has become more challenging. All of these factors are contributing to a challenging environment for M&A.

Unlike in many other sectors, however, we do not currently expect that the pandemic will lead to insurers selling off assets to deal with solvency issues. According to the Prudential Regulation Authority (the PRA), information from the largest UK insurers showed the industry was well-capitalised going into the COVID-19 crisis and that has so far remained the case, with aggregate solvency ratios around 150%. In addition, Solvency II has a number of counter-cyclical elements which reduce the impact and stress of significant market movements and economic crises, such as the Matching Adjustment, the Volatility Adjustment and the Standard Formula Symmetric Adjustment of the Equity Capital Charge. UK regulators have also provided guidance to insurers in cases where Solvency II might be unhelpfully misinterpreted to avoid unintended consequences, for example, on the PRA's position on the treatment of covenant breaches and insurers' internal ratings during COVID-19. Further, the PRA has also invited insurers to recalculate their transitional measure on technical provisions (or TMTP) in light of the significant changes in interest rates which we have seen.

This resilience has been reflected in levels of insurance M&A activity, which have so far held up better than in many other sectors. According to data from Mergermarket, while the global volume of M&A transactions across all sectors dropped by approximately 30% in the period 1 January 2020 to 1 June 2020 compared with the equivalent period in 2019, the volume of deals in the insurance sector was down only 12% over the equivalent period, with aggregate disclosed deal value up 72% (from approximately £30 billion to £51.8 billion). However, the sector has not been entirely immune, with many insurers putting their strategic projects on hold. This has enabled them to focus on shoring up liquidity and dealing with the immediate operational impacts of the pandemic, including ensuring their customer-facing operations continue to function effectively and complying with the Financial Conduct Authority's (the FCA) measures for supporting customers.

Despite the uncertainty created by the pandemic, insurers have not been standing still. In recent weeks, we have seen some London listed insurers, including Beazley, Hiscox and Lancashire, take advantage of market conditions and raise capital through equity issues. These capital raises were not undertaken to improve liquidity but rather to provide funds to exploit future market

Some of the key drivers of M&A in the insurance sector

Technology

Technology is expanding its influence over the insurance industry. COVID-19 will only increase the rate of technology expansion particularly in the health insurance sector as, amongst other things, the pandemic has encouraged physicians and patients to turn to virtual health solutions. Further, automation and digitalisation are becoming ever more important to achieving efficiency, and insurers are increasingly turning to data analytics, intelligent pricing and telematics to help price products more competitively. Added to which traditional insurers are under threat from new, digitally-enhanced entrants and established tech companies may come to threaten the market position of traditional insurers particularly in personal lines business.

M&A (whether by way of acquisitions, investments or joint ventures) could provide the fastest way for insurers to improve in-house capabilities and counter the threat of new entrants.

The global economy

The current economic backdrop of challenging market conditions/recession, low interest rates and increasing compliance costs may encourage some insurers in mature markets to consider seeking synergies through consolidation both domestically and overseas. The low and possibly negative interest rate environment is also likely to lead to insurers investing more heavily in long-term and illiquid investments such as infrastructure, debt portfolios and private equity which provide better yields than more conventional investments. Further, the adverse impact of COVID-19 on certain sectors (such as the retail and hospitality sectors) coupled with the significant drops in share prices has led, and is likely to continue to lead, insurers to rebalance equity holdings. ***Continued on the next page.***

opportunities. They were undertaken by way of placings of new shares on a non-pre-emptive basis. In addition to these issuances, in the last week we have had the news that Lemonade, the insurance start-up founded in 2015, is seeking a listing of its shares on the New York Stock Exchange.

As far as insurance sector M&A is concerned, once the COVID-19 crisis stabilises, activity can be expected to pick up again as the key pre-COVID-19 drivers of M&A in the sector will almost certainly not have changed. Some commentators also argue that insurance M&A activity could be driven by private equity firms with significant funds at their disposal. In particular, the intermediary sector, which some see as potentially being damaged by the pandemic, could offer consolidation opportunities for private equity buyers who have traditionally dominated historic acquisitions in this sector.

Of course, the level of insurance M&A activity is not only impacted by the pandemic. Other factors, such as Brexit, increasing regulatory scrutiny in the U.S., on-going trade wars and U.S. tax reform legislation may impact insurance M&A deal volumes. We may also see increasing shareholder activism in the sector which may deter some buyers.

Against that background, this briefing looks at some M&A structures that may be used by insurers to deliver their objectives and highlights some of the key legal issues for consideration.

For further analysis on navigating opportunities in uncertain waters see the Hogan Lovells guide *Negotiating M&A transactions in the COVID-19 era: considerations for navigating new opportunities in uncertain waters*.

Investments in companies (private and/or listed); takeovers of listed target

For investments in private companies, the relevant transaction documents will comprise an agreement among the shareholders and articles of association. A buyer will need to consider what protections are required before investing; such as drag/tag rights, board representation, veto rights, anti-dilution etc. Due diligence will also need to be considered.

By comparison, if an investment is to be made in a listed company then, depending upon the size of the investment, a relationship agreement with the company may be required and the new investor may seek a board seat. However, other protections seen in a private company context (such as veto rights) will not be available to the investor.

Additionally, if taking a very large stake, the investor will need to take advice on whether there is a need to consolidate the investment for accounting purposes and, where the target company is regulated, regulatory capital/consolidation supervision issues will need to be analysed carefully.

When investing in a listed entity, buyers will have to tread carefully as the rules and regulations governing public markets transactions can create traps for the unwary. For those who have undertaken significant public markets transactions, they will be aware that the entire process looks and feels very different from a traditional M&A process. By way of example, if a takeover of a UK listed target is undertaken, that acquisition will be governed by the UK City Code on Takeovers and Mergers and will require specialist legal advice from a very early stage.

For public market processes, there will be little or no opportunity to undertake due diligence save for reviewing information that is publicly available. Investors will therefore have to take a view on the assets they are acquiring and the price they are prepared to pay. However, UK publicly listed companies are required by the Market Abuse Regulation (MAR) to make market disclosures of all material information. This means that a thorough review of the publicly available material will go a long way in helping to identify material matters of concern.

Some of the key drivers of M&A in the insurance sector (*continued)*

Japanese and Chinese outbound investment

Historically, limited domestic opportunities have encouraged Japanese insurers to invest overseas. Almost all have ambitions to increase premium income from overseas. Chinese insurers have similarly taken an interest in outbound opportunities but are challenged by Chinese capital controls and there is a perception of governance issues as a result of recent problems. The on-going U.S./China trade war and other protectionist measures may dampen the enthusiasm of Chinese investors particularly for U.S. investments.

The continuing regulatory burden

Increasingly intrusive regulators and other regulatory developments such as the senior managers regime are putting considerable pressure on directors and senior management. Risks associated with cyber-attacks and data privacy, and the reputational damage that can be caused, in particular have made organisations much more risk-adverse. Some corporates will look to divest non-core assets in an attempt to minimise this burden.

Care must also be taken with the change of control requirements of the Financial Services and Markets Act 2000 (FSMA). Under FSMA, prior approval of a change of control of a UK regulated insurance company must be obtained from UK regulators. This applies not just for an acquisition of a majority holding, but also for an acquisition of as little as 10%, of the shares or voting rights of an insurance company. For these purposes, the holdings of persons acting in concert are aggregated.

The box headed "*Further considerations for London listed companies*" (page 5) sets out certain other rules and regulations that may need to be considered.

Distressed M&A

As a consequence of the pandemic, we may see some distressed M&A. For those who have not previously been involved in a distressed M&A process, it can be all very daunting. There is usually a highly accelerated timetable making both the valuation of assets and the ability to conduct adequate due diligence difficult. Heavier reliance than normal on alternative means to undertake due diligence may be required including management interviews and a buyer (and its advisers) may need to be more creative than usual in finding ways to allocate risk for identified issues

Whilst unusual, distressed M&A processes are not wholly unknown in relation to insurance companies. Those that do take place, however, are likely to be undertaken in a very different way to other sectors. This is because of the new rules introduced by Solvency II which require EEA regulators to take steps to restore the solvency of an insurance company and the PRA's "ladder of intervention". This allows an insurer that fails to meet its Solvency Capital Requirement (SCR) some time to work with the regulator to find a solution to restore their compliance with the SCR. This is as an additional regulatory tool to promote the safety and soundness of UK insurers and to protect policyholders by avoiding a “cliff-edge” effect of a winding-up.

Buyers should beware however of distressed M&A processes involving insurance companies with financial difficulties. UK regulators are able to give their approval of change of control under FSMA subject to conditions, and these conditions could include a requirement that the buyer re-capitalise the target company and undertake not to take dividends until certain financial thresholds or objectives are met. In addition, there may be restructuring costs which a buyer will want the seller to pick up, and the viability of new business activities may need to be considered. Breaches of contractual warranties and covenants may need to be discussed with counterparties. Price adjustment mechanisms may be appropriate to take account of these and other issues. A buyer may also not become aware of the full extent of the target company's problems until final, confirmatory due diligence is undertaken at the end of the sale process.

If an insurer becomes involved on the buy-side in a distressed M&A process, it should note the following key points:

- *agree the transaction structure early on*

  When acquiring any business (whether an insurance business or one operating in the tech sector), a buyer will need to consider whether it prefers to acquire a specific portfolio of assets and liabilities and leave behind unwanted liabilities; a business and asset purchase. The alternative would be to acquire shares in a company which will often be the seller's preference.

  On a transaction involving an insurance business, if the seller agrees to a business and asset transfer, the legal transfer of a portfolio of insurance or reinsurance contracts will likely require the parties to undertake a lengthy local law process (such as a Part VII transfer) and obtain regulatory or even court approval. A buyer should also consider whether a temporary or permanent reinsurance arrangement might be a preferable transaction structure.

- *agree the scope of due diligence early on*

  Each buyer is likely to have its own specific requirements for due diligence. It is worth stressing that ownership of critical intellectual property can often be an issue when acquiring a tech target. Getting to the bottom of this particular issue early in the transaction timeline is important.

  Additionally, on tech M&A transactions, it is often the case that the target and its business are wrapped up in one or maybe a small handful of individuals. Understanding employment and other arrangements will be key. If the existing arrangements are not adequate, a buyer will need to consider whether it should be made a condition to closing that this individual or group of individuals enter into new service agreements as a condition to closing. The extent and enforceability of any restrictive covenants should also be considered.

What is clear, however, is that there will be less time available on a distressed process to undertake due diligence. A buyer must therefore move quickly and focus on what is important.

- *assess the covenant strength of the seller and possibly look for solutions if the seller's covenant strength is poor*

  In these circumstances, contingent/deferred consideration, retention accounts and/or price adjustments may be required. Additionally a warranty and indemnity insurance policy might help if the seller's covenant is weak.

- *obtain all required third party consents to the acquisition from relevant regulators*

  For example, from the PRA, FCA or the Competition and Markets Authority. As noted previously, in the UK, under the FSMA change of control rules, regulatory approval will be required as a condition to the acquisition of shares or voting rights in a UK insurer of 10% of more. This will impact timetable.

- *London listed buyer or seller*

  If either the buyer or the seller is a London listed entity then there are further rules and regulations that will need to be considered. For detail, see the box on the right.

Further considerations for London listed companies

If either the buyer or the seller is a London listed entity then there are further rules and regulations that will need to be considered in the context of the transaction, including:

- for those companies listed on the Main List, a key question will be whether, as a condition to the transaction completing, shareholder approval is required. This would be necessary if the transaction is classified as a related party transaction or a Class 1 transaction under the Listing Rules. If shareholder approval is required, this will require the preparation of a circular to shareholders for the purpose of convening a general meeting. This all takes time;

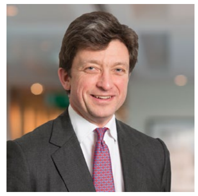
- be aware that if there is a leak to the market of the possible transaction before the parties are ready to announce it, then there may be a need to make a statement to the market about the transaction in order to comply with MAR obligations;

- considering the consequences under the rules of the City Code on Takeovers and Mergers; for example, if the stake acquired exceeds 30% or more of the voting rights of the target, then target shareholder consent to waive the requirement to make a Rule 9 mandatory offer for the target would be required. Again, this will require the preparation of a circular to shareholders for the purpose of convening a general meeting with the consequential timing impact; and

- if shares are to be issued by the buyer as consideration or by the target where a corporate is taking a strategic stake in the target, the requirement for shareholder approval to allot new shares or to disapply the pre-emption rights which would otherwise arise on the issue of new shares will need to be analysed. If shareholder approval is required, this will require the preparation of a circular to target shareholders for the purpose of convening a general meeting which will add to the transaction timeline. A prospectus for the new shares may also be required.

Contacts

Nicola Evans
Partner, London
T +44 20 7296 2861
nicola.evans@hoganlovells.com



Charles Rix
Partner, London
T +44 20 7296 5425
charles.rix@hoganlovells.com

Jonathan Russell
Partner, London
T +44 20 7296 5812
jonathan.russell@hoganlovells.com