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INSURANCE – DEAL FACILITATING TOOL THROUGH THE ENTIRE REAL ESTATE LIFE CYCLE

Interview with Olena Vlasyuk – Head of M&A and Transaction Solutions, Christophe Bonneville – Director Tax Solutions, Salomon Journo – Deputy Global Head of Development


Olena Vlasyuk


Christophe Bonneville


Salomon Journo

AON

► ***What kind of services can an insurance broker offer to its real estate clients?***

Olena Vlasyuk: Aon specialists assist our real estate clients with the solutions through the entire real estate life cycle – from acquisition of property or shares to their disposal.

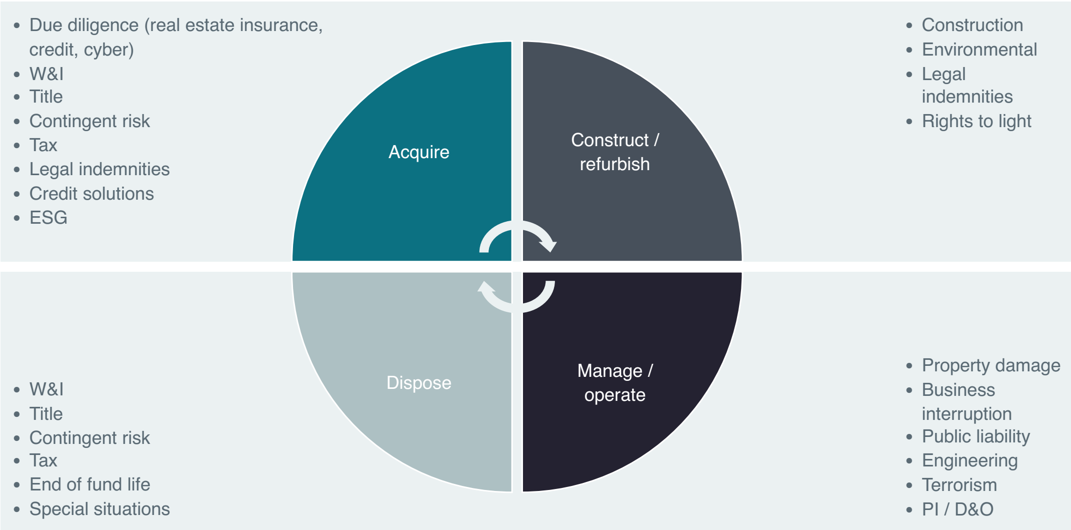
The chart on the next page summarizes the scope of our services during each real estate life cycle and, as you can see, this scope is very broad and involves skills of various professionals.

We intervene on the entire life cycle of value chain of real estate transactions for all types of players in the sector, both real estate promotors, who buy land to construct but also asset managers, who invest in existing assets.

Our goal is twofold – to facilitate the real estate transactions (both on the by-side and on the sell-side) and to maximize returns on investment for our clients.

For instance, when clients decide to purchase shares in a real-estate company, we assist them with placement of Warranty and Indemnity Insurance (W&I Insurance) for which the demand has grown exponentially in recent years. This insurance covers loss resulting from breach of representations and warranties given by the seller in the Share Purchase Agreement and generally allows the seller to benefit from clean exit.

W&I Insurance facilitates discussions between parties and helps them avoid tensions when it comes to negotiating the retention, the seller's cap or the survival period of representations and warranties given by the seller in the SPA. Also,



it provides comfort that any potential claims will be handled without impacting the ongoing relationship between the parties.

W&I Insurance replaces any financial guaranties / escrow requested by the buyer in the non-insured deals. Historically W&I Insurance was a transactional tool that helped parties get the deal through and it is nowadays becoming a real insurance tool given the increased number of policies that have been activated.

On some deals parties must deal with identified risks, that can be deal breakers. Such identified risks cannot be covered under W&I Insurance, but there are specific insurance policies that can cover various identified risks. Such identified risks solutions, ubiquitous on the Anglo-Saxon market, are becoming increasingly market standard on real estate transactions in Europe.

Christophe Bonneville: Among the insurance policies which allow you to secure an identified risk, referred to by Olena, it is not possible not to mention Tax Insurance, which has grown exponentially in the last 2 years.

Tax Insurance for instance will enable buyers to avoid having to require a price chip or a specific indemnity for the identified tax risk of the target, with the tax policy providing a complementary cover to the W&I Insurance. It can also cover the tax risks of the transaction itself, like Real Estate Transfer tax, or VAT for instance.

Last but not least, Tax Insurance helps parties more and more frequently in the structuring of their funds as well as in addressing issues stemming from the cash repatriation.

Salomon Journo: In parallel to all of the solutions catering to identified / non identified risks mentioned by my colleagues, there is another area where we intervene a lot for real estate clients: namely, financial guarantees that we put in place before, during and after the acquisition.

These financial guarantees, which initially came from the legislation (GFA, GPE…), have become a true hybrid tool, which can take different forms depending on the purpose of the guarantee and the interests of both parties to secure a transaction but also enables access to funding resources.

We are currently working with 10+ insurers who have significant appetite to explore new deal structures. The market has learnt and adapted itself thanks to our clients. In comparison to the banking market which is also able to deliver this kind of guarantees, the insurance market is more flexible on the cost of these guarantees but also on the conditions of their implementation (wording, cash-collateral etc.).

► ***How can insurance solutions simplify real estate transactions?***

Olena Vlasyuk: First of all, as a result of the inflation and the increased cost of debt, the M&A market has slowed down, the number of transactions has decreased, and the real estate sector is much more affected than other sectors, such as health, tech or infrastructure. In this context, all transactional tools, that can help get the deal through should be explored by the parties.

As to the W&I Insurance, it can be quite useful to accelerate the sales process and to facilitate a clean exit for the seller, as many of them are quite reluctant to give representations and warranties, in particular if the seller has to be liquidated. A W&I Insurance can also serve as an advantage in a competitive bidding process.

When it comes to identified risks, they can be quite varied in the real estate sector and can jeopardize the completion of the project. In many situations insurance allows parties to get around the identified risk obstacle and to externalize the financial exposure arising from the risk to the insurer. For instance, Title Insurance covers title to property or defects on title, such as irregularities in the chain of title to property or irregular division of the property.

There are also insurance products which cover the validity of building permits and allow real estate players to cover any potential financial losses that would be incurred in case of permit cancellation. Such insurance can also be requested by the bank that finances the project to secure the release of funds in the event that the project gets challenged by third parties, which happens quite often. We have recently covered a warehouse project with a missing environmental permit, a project with irregularities in the building permit and several permits challenged by neighbors or associations. The increased advisors' awareness of these products has helped to unblock many transactions that could never have been completed without significant price chip or financial guarantee provided by the seller.

We are receiving increasingly more requests relating to identified risks. The nature of these risks is very different and it is clear that the appetite of insurers for identified risks has increased significantly.

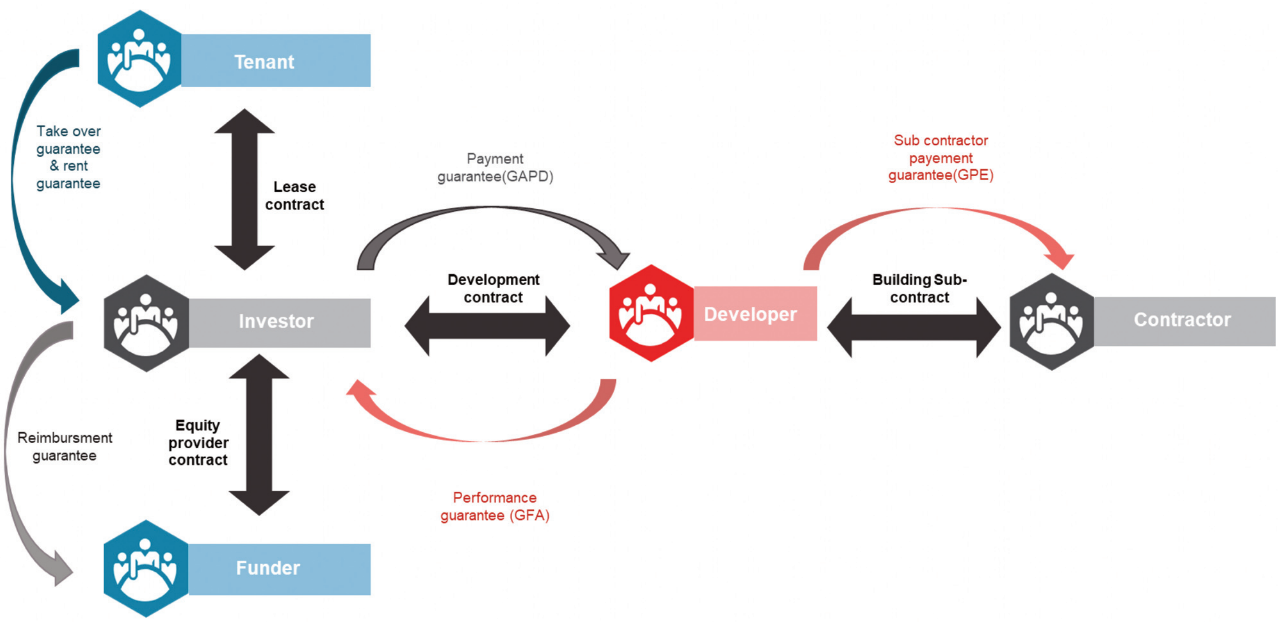
Christophe Bonneville: As to the Tax Insurance, it can be used either as a complement to the W&I Insurance, for identified tax risks of the target, or to cover risks of the transaction themselves.

In a deal environment where sellers are accustomed to having a "clean exit" in their deals, insurance is a great alternative to the traditional deal protections of a price chip or a specific seller indemnity. Risks of the target such as the well-known French 3%, interest rates of shareholder loans, application of tax-exempt regimes, just to name a few, are frequently insured. From the auction bidder's perspective, it can make a bid stand out if buyside Tax Insurance is used to manage an identified tax risk without having to ask for a traditional deal protection from the seller. As for sellers, the most sophisticated ones sometimes proactively approach the insurance market ahead of an exit process. If vendor due diligence has highlighted a material tax risk, the seller sometimes seeks competitively priced insurance quotes which can then be "stapled" in the deal process so that the buyers have a "level playing field" and can make their best offers with that identified issue already resolved for a known cost.

Regarding the risks of the transaction itself, Tax Insurance can really help enable a seller and a buyer to agree to a preferred deal structure without taking on additional tax risks. In many instances, the preferred transaction structure of either the seller or the buyer may entail risks for either party and negotiations can then become complicated. Tax Insurance, by covering the risk thus generated by the preferred option, greatly facilitates the negotiations. We see clients who tell us that without the insurance, the deal would not have gone through.

To take a simple example, the application of the VAT exemption of an asset deemed to be a "universal transfer of assets" is frequently uncertain. Even when the question seems benign because the treatment can be corrected when both parties have agreed to it in the event of a future challenge by the tax administration, the risk that the buyer, or the seller in some cases, may no longer be in existence at the time that the correction must be made, or even the question of the financing of the VAT in these specific cases, can delay, or sometimes even jeopardize the completion of the transaction. Covering the risk through Tax Insurance is the perfect remedy to these situations.

Salomon Journo: The financial guarantees can be used both to secure partners on their ability to honour their commitments, but also to obtain cash and loans necessary to the progress the transaction.



Example (see graphic on the previous page): An investor can request a performance guarantee from the developer in order to obtain equity from a funder and in parallel the bank, who fund the developer, can request the developer to obtain a payment guarantee from the investor to cover future payments.

The scope of these financials guarantees is not limited only to the pure construction / acquisition players, but they are also frequently used and requested to secure future relationships / revenue between the tenant and investor (who is generally a landlord). For instance, we have secured several transactions with a significant financial exposure in case of "no show" of the tenant after delivery of the premises or in case of default of rent payment during the term of the lease.

The type of guarantees evolves with each transaction depending on the needs of each party with the market demonstrating good flexibility.

► ***Do you see the evolution in your clients' needs and how does insurance adapt to such evolution?***

Olena Vlasyuk: Yes, we definitely see evolution in our client's needs and requests, and they drive changes in the insurance market. It is important to note that the number of insurers has grown significantly over the last couple of years, which has created a very competitive environment and allowed us to push the boundaries. For instance, a couple of years ago insurers were not willing to accept a deal structure without the seller's financial exposure and today a 1€ seller cap has become market practice. The same observation applies in respect of policy retentions. A couple of years ago, insurers were applying a retention on deals in all sectors, including real estate. Nowadays, there are no retentions on pure real estate projects and the de minimis does not apply to fundamental warranties. This makes insurance a very attractive product compared to non-insured deal where the seller would not accept a financial exposure without the retention.

Some insurers have also accepted to provide coverage for new breaches arising between signing and closing on real estate deals through the new breach coverage option. This evolution is also the response to the request made by numerous real estate players who wanted to exonerate themselves from any responsibility for this period between signing and closing.

Another innovation in the insurance market that reflects the evolution of our clients' needs is synthetic warranties package offered by several carriers for real estate deals.

Christophe Bonneville: Regarding Tax Insurance, over recent years the appetite of the insurance market has expanded considerably, but it remains the case that clients tend to come to us in situations where they are facing a relatively low probability, but potentially highly financially damaging tax risk. These are sometimes described as "low" or "medium" likelihood risks in Due Diligence reports. These are the kinds of risks which, in Real Estate, are difficult to manage through some of the more "traditional" deal protection options such as a price reduction or escrow.

Recently we have seen increased appetite amongst some insurers to cover slightly riskier issues – for instance tax situations which are already under audit or have been adversely assessed.

Historically, most of the risks which came to market were "technical" in nature. By this we mean situations where the relevant factual position is clearly understood; but the way in which the tax authorities might apply the law to those facts is not clear cut. That said, we have also been driving an expansion of insurer appetite into other areas of uncertainty – for instance, questions of valuation or economics – like whether a company is "land rich" for real estate transfer tax purposes.

Another interesting trend is the evolution towards more forward-looking risks. In the early days of the market, nearly all of the risks insured were "historic" in nature. The potentially taxable event had already taken place, and the question was whether this event could be audited. Nowadays we see a significant number of so-called "forward-looking" tax policies, where taxpayers would seek to cover the treatment of events which have not yet occurred – a future sale, cross border distribution in the frame of the cash repatriation, or restructuring, for instance. Clients use the insurance as a substitute or supplement to a traditional tax authority clearance or ruling – getting the certainty of treatment that they need, but from the insurance market rather than an unpredictable tax authority.

Salomon Journo: As I said before, the type of financial guarantees and their use evolves according to the needs of the market and the demands of the stakeholders on the projects. For instance, we note significant gaps between the guarantees requested by the banks, which are quite different from those requested by PEs, who can finance a transaction or finance equity needed to obtain a loan from the bank.

On the topic of funding, we have recently been approached to structure a pure alternative financing solution (for the developer) in order to obtain at signing, the total amount of the contract up-front in order to increase liquidity and be able to carry out more operations. This kind of request secures all parties and reduces risks (outlined below) around the operation in order to obtain the greenlight from alternative funders:

- Risk of failure of the developer
- Risk of non-payment of the investor
- Risk of recourse by any third parties

This type of requests is definitely linked to the tension in the current real estate market, but also in the liquidity markets (banks), which can represent a systemic risk for players in this industry.