

Is the Target Really a Big Environmental Risk?

A business-like approach to environmental inquiry can speed up dealmaking

In the early days of environmental due diligence, many good deals were hampered by the consultant's inability to properly define and communicate the environmental liabilities. Multi-million-dollar deals were delayed or cancelled due to uncertainty about relatively minor environmental issues. At times, inordinate time and money were invested to further quantify environmental liabilities that were negligible when compared with the size of the deal and overall due diligence costs.



By Guest Writers
Philip G. Newton and David M. Pasquinelli

Many environmental consultants are trained to resolve technical problems. But equity investors are focused on a targeted return on investment and need sound financial information. What we have learned in years of providing environmental due diligence services is that effective business-oriented environmental due diligence must go beyond technical ability to identify environmental risks. It must provide deal participants with an understanding of these risks in financial terms to support informed business decisions.

Effective environmental due diligence requires bridging this communication gap. The consultant must possess an "investor orientation" that includes a pragmatic assessment of environmental risks, development of plans and budgets to mitigate the identified issues, and the ability to work with the management team in implementing the plans. It is important at the outset of a diligence effort for the consultant to understand stakeholders' risk appetite, materiality threshold for environmental risk, and their overall goals. From that starting point, an effective and pragmatic diligence program can be implemented.

Identifying and quantifying environmental risks

The industry standard for assessing environmental risks is commonly referred to as a Phase I environmental site assessment. This approach has many benefits and may be required by certain lenders, but a Phase I may not always be feasible or the most efficient use of available time and resources.

Case Example: Nationwide parking company

An equity sponsor wanted to acquire a privately held parking business that owned more than a thousand locations. The proposed financial terms were highly favorable from both a debt and equity perspective, but consummating the deal meant a limited window for due diligence, and economic realities did not allow for assessing individual sites. Both the buyer and the lender were willing to accept a reasonable amount of environmental risk given the financial strength of the business, but both had a fiduciary responsibility to investigate the relevant environmental exposure.

Given these circumstances, the recommended environmental due diligence scope focused on the historical use of

Deals that consolidate operations and increase production in the combined facility may significantly impact environmental permit requirements.

the properties given their "convenience" locations, as the parking operations represented a very limited environmental risk. Sites were identified that historically had operated environmentally sensitive businesses, such as gas stations, dry cleaners, and manufacturing. Conversely, other properties were "greenfield" locations prior to the existing use.

A site risk profile was compiled and the sites divided into low-, moderate-, and high-risk categories based on former use. Phase I assessments were performed

on a subset in each risk category to test the risk-ranking model, which was confirmed. This process allowed for an estimate of environmental liability company-wide. Additionally, umbrella pollution liability insurance was secured as a means to cap the unknown risks associated with the transaction, thereby limiting the downside risk exposure for the investment.

Today, effectively identifying and quantifying environmental risks requires considerably more than the ability to complete a Phase I. Deal-oriented environmental consultants must differentiate between the liabilities that exist in stock deals versus asset deals. They must understand the relative risk profile of the lender and how the identified liabilities will be evaluated and then provide practical risk management solutions. This requires that environmental findings be presented appropriately in a deal context, which differs from transaction to transaction and from one party to another in the same deal.

Are there hidden environmental matters in a deal?

Environmental liability can be found in many areas of a deal. Frequently, the environmental due diligence effort is too narrowly focused on existing real estate. Significant environmental liability can also be associated with current and future compliance with environmental regulations and, in the case of stock deals, there can be risk associated with historical off-site waste disposal practices and former locations and subsidiaries. Due diligence should incorporate a review of these potential exposures.

Case Example: Nursery crafts business

The transaction involved a large nursery crafts entity. Initial environmental due diligence did not identify any significant issues. However, the company was the last significant asset owned by a holding company and the deal

involved the acquisition of holding company stock. Due diligence revealed that the holding company had previously owned businesses in environmentally sensitive industries, including convenience stores with fueling services, leather tanning operations, and mining. In certain cases, the businesses had been sold and the environmental liabilities retained in the form of indemnities.

Legal counsel was unable to completely define these "legacy" liabilities, but a comprehensive review of these operations allowed the buyer to make an informed decision regarding these risks and provide for them by virtue of a price reduction.

How can you manage known or perceived environmental risk?

Once environmental issues have been identified, quantified, and scheduled in the closing documents, it is not uncommon for the portfolio management team to "lose religion" after closing and fail to address the issues identified. Other pressing business issues take priority and before issues have been addressed, the business is being sold or refinanced and the environmental and compliance problems remain unresolved.

This lack of urgency reflects badly on the management team and may also result in agency fines and other added costs due to delayed action. But the situation can be avoided with a more proactive and integrated approach to environmental management. A business-oriented consultant can maintain the relationship with management after closing and continue to add value by providing outsourced environmental services. These services may include periodic compliance audits, resolution of identified environmental issues, or the implementation of an Environmental Management System (EMS).

Developing a consolidated EMS provides consistent policies, standard operating procedures, and an organizational structure that defines responsibility and accountability. The self-audit program established within the EMS would identify and facilitate the resolution of concerns



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immediately, which in turn could prevent issues from arising at a potential exit. Furthermore, a comprehensive EMS will identify opportunities to consolidate vendor contracts and obtain volume discounts.

It is more the rule than the exception that equity groups own portfolio companies that were last subjected to environmental review at the time of purchase. Many dealmakers know from experience that environmental issues can emerge at the negotiating table that result in costly discussions to establish escrows or purchase price discounts.

An EMS helps to eliminate surprises in new investments, but may take too long to implement for companies where the exit is imminent. When the Confidential Memorandum is distributed, a

selling equity group can either wait for the buyer to perform due diligence and address the technical findings during negotiations or perform audits in advance to prepare the company for sale, thereby mitigating surprises. Divestiture audits can take minor issues off the table and allow equity sponsors to respond to any meaningful issues that cannot be corrected prior to the offering.

Can value be found in perceived environmental risk?

Business-oriented environmental consultants recognize that protecting the interests of investors requires that they go beyond industry norms for assessing potential environmental liabilities associated with former or current operations. By maintaining a focus on the goals of investors, the environmental consultant can add significant value to the transaction.

Case Example: Middle-market manufacturer

A sponsor was interested in buying a mid-market manufacturing company that had performed extensive environmental remediation at considerable costs for several decades. Existing environmental liabilities were significant, but they were well understood and mature enough to be easily estimated.

Given this history, the environmental consultant

requested that the firm provide historical information relating to its general liability insurance policies. Upon review, it became clear that historical and future environmental remediation costs incurred by the company were recoverable under the insurance policies. The sponsor was able to acquire the company for a reasonable price. Eighteen months later, the consultant recovered \$1.5 million in insurance proceeds for the sponsor.

Will environmental risks impact the business plan?

The effective environmental consultant strives to understand the nature and constraints of the deal as well as the future business goals for the target company.

Case Example: New manufacturing company

An equity firm was looking to acquire a majority interest in two competing manufacturers that serviced the automotive industry. Both owned regional facilities where the average output from the operations ranged from 40% to 60% of capacity. The prospective investor saw an opportunity to consolidate manufacturing while reducing operating and overhead costs.

The scope of work for environmental due diligence could have simply included a Phase I assessment for each facility. However, this approach would have ignored the risks associated with the acquisition strategy. By closing sites, the purchaser would face decommissioning costs that needed to be included in projections of future costs. In addition, increasing production by combining operations would cause environmental permit limitations to be exceeded and require the installation of pollution control equipment. These capital costs also needed to be added to the mix.

Transactions that consolidate operations and increase production in the combined facility may significantly impact environmental permit requirements. Any increase in air emissions, water discharges, or waste disposal can require permit modifications and the installation of pollution control systems. It is essential to properly characterize the environmental requirements of anticipated facility clo-



Significant environmental liability can be associated with off-site waste disposal practices and former locations and subsidiaries.

tures, production increases, and new regulatory requirements and trends. By understanding an acquirer's business strategy, the due diligence team can refine its scope of work and address factors that might otherwise be ignored.

The Bottom Line

Value-added environmental due diligence requires a combination of technical, regulatory, business management, and financial knowledge and skills. It requires effective communication at all management levels and the ability to distill and convey complex environmental issues in non-technical terms. A deal-oriented due diligence environmental consultant can greatly assist investors by:

- Effectively identifying, quantifying, and communicating the environmental risks;
- Uncovering the hidden environmental issues and value in a deal; and
- Assisting in the management of known or perceived environmental risks.

Most important, the deal team is looking for a partner that can confidently assess environmental liabilities, address the needs of all deal participants, and remove the uncertainty surrounding environmental and compliance issues. This must be accomplished on short notice, within the due diligence schedule, and on a reasonable project budget. Once a liability value is determined for the environmental risk exposure, investors can make an informed decision on the overall merits of the deal.

A proactive business-oriented approach to environmental due diligence and management will continually demonstrate value. It benefits the deal team during due diligence, allows the portfolio company management team to focus on business issues after closing, and protects the investment exit. Finally, it helps to secure the return on investment and assure value over the longer term. ■

Philip Newton is President and Founder, and **David Pasquinelli** is Senior Vice President, of GaiaTech, a Chicago-based environmental engineering and consulting firm. This article was reprinted from *Merger Monthly*, published by Robert W. Baird Inc.