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TRANSACTION SERVICES

Impact -
A survey on environmental due diligence

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Key insights

Environmental due diligence (EDD) has become an important feature of an increasing number of merger and acquisition (M&A) transactions. Interestingly, however, it is not automatically included in the approach many companies take to transaction evaluation, even in sectors at the greatest risk from health, safety, social and environmental (HSSE) issues.

For some organizations, simply starting to consider HSSE issues can significantly help reduce the risk of unpleasant post acquisition surprises when they undertake an M&A transaction.

Those undertaking EDD often find the transaction is influenced by the HSSE findings, with valuation and/or contract adjustments and even deal breaker outcomes being cited by approximately half the interviewees. However, companies do not always identify all the material issues. One third of companies interviewed indicated that they have been impacted by material HSSE issues post transaction. A key explanation is that the landscape of HSSE risk is evolving, and the manner by which these risks can impact business performance is expanding into areas not always covered by a traditional EDD exercise.

Legal and financial (capital and operating expenditure and liabilities) consequences of HSSE issues remain fundamental to most EDD investigations. But HSSE issues now also impact other business performance variables such as sales, operations, customer relations and reputation – each of which can directly impact the key transaction ‘check points’ of: sale and purchase agreement; valuation model (and assumptions); deal breaker evaluation; acquisition accounting; post acquisition action planning; and exit strategy (where applicable).

While some companies have made the transition towards a more commercially oriented EDD process, others are part way through the transition, having adapted their assessment process to take account of the business performance issues, but not yet altering the EDD scope.

One of the critical success factors is for companies is to have a commercially driven scoping and assessment approach which integrates EDD findings into the legal, commercial and financial due diligence assessments, underpinned by robust technical competencies. The survey data indicates these are the companies which are suffering fewer material issues arising post acquisition and in the long run are more likely to have their M&A succeed.

Summary of findings

Our research, conducted by KPMG LLP (UK), among Europe's leading quoted companies shows that EDD is an increasingly important aspect of M&A transactions. This is particularly true for companies in what we classified as 'risky' sectors described in Chart 1 overleaf.

Usage of EDD:

- 83 percent of companies in Risk Category 1 and 42 percent in Risk Category 2 sectors normally use EDD when doing an M&A transaction.
- 8 percent of companies in Risk Category 1 and more than a third in Risk Category 2 do not conduct EDD when doing an M&A transaction.

Failure to identify material issues:

- Almost a third of all companies interviewed discovered significant environmental issues after completing a transaction.
- Of the companies that discovered a significant environmental issue post deal, three out of five had carried out EDD.
- Where an issue was discovered post deal, 42 percent of companies found it resulted in higher operating costs and 21 percent of companies found they had financial liabilities directly attributed to the issue.
- Key factors contributing to companies missing material issues included: not undertaking EDD; constraints placed on the EDD process by the vendor; absence of management procedures; failure to take into account the full range of business performance implications of HSSE issues; and not integrating the EDD findings into other 'overlapping' due diligence team assessments.

Impact of EDD on a transaction:

- When undertaking EDD during an M&A transaction, 67 percent of Risk Category 1 companies and 33 percent of Risk Category 2 companies say that negative findings have led them to pull out of a transaction.
- EDD results have led to a renegotiating of price in 64 percent of cases for Risk Category 1 and 48 percent in Risk Category 2.
- EDD results have led to the addition of warranties or indemnities in 56 percent of cases for Risk Category 1 and 48 percent for Risk Category 2.
- Seven out of 10 companies from both Risk Categories 1 and 2 have either pulled out of, renegotiated or restructured a deal, or set up an escrow or insurance solution as a result of HSSE issues emerging during EDD.

Broadening the scope of due diligence:

- While many companies now assess the commercial and reputation consequences of HSSE issues, a significant minority do not.
- Those which do the assessment, identify material issues on a frequent basis which impact the value, contract and can even break the deal.

Conventional issues:

- Technical issues such as contaminated land and regulatory compliance remain fundamental to most investigations, and require robust technical skills during assessment.

The research

Our research, conducted by KPMG LLP (UK), set out to discover the extent to which EDD is integrated in the due diligence process and manages to identify important issues. In particular, we explored the commercial impact of environmental issues, and the brand or reputation risks associated with these – both issues which our 2002 UK survey, *Environmental due diligence: A survey of major UK companies*, indicated to be emerging and of key importance.

The research was undertaken by TNS Financial & Professional Services, which conducted 105 telephone interviews. The companies interviewed were selected from the top 500 quoted companies in Europe by stock market value. The individuals interviewed worked in HSSE roles and had recently taken part in an M&A transaction.

The top 500 companies were divided into three risk categories, based on their industry sectors. Our research focused on Risk Categories 1 and 2.

A total of 72 companies were interviewed from Risk Category 1; 33 from Risk Category 2. The results of the survey are therefore biased towards the companies likely to be affected by HSSE issues, rather than representative of the full population of companies.

Chart 1: Risk Category definitions

Risk Category 1	Aerospace and defence; automobiles and parts; chemicals; construction & building materials; diversified industrial; electricity; food producers & processors; mining; oil & gas; pharmaceuticals & biotechnology; steel & other metals; utilities; venture capital
Risk Category 2	Banks; beverages; electronic and electrical equipment; health; household goods and textiles; information technology hardware; investment companies; real estate; speciality & other finance; telecommunication services; tobacco

Avoiding the pitfalls

EDD sometimes misses material issues

Our research shows that not only do some companies not undertake EDD but many companies which routinely do EDD are nevertheless caught out. It is clear that some assessments do fail to identify material issues, as these HSSE managers indicated:

"We probably didn't specify the EDD well enough and didn't go deep enough."

"The whole study was not managed very well. There was not enough focus."

Some issues are not specific to EDD, for example, time and access constraints enforced by a vendor. However the research does demonstrate that if the EDD aspect of an M&A transaction is controlled and managed more effectively by an acquirer, the risks can be reduced significantly.

Good management procedures and guidance

Part of the management and guidance issue lies in assessing the findings of the EDD more effectively. Another aspect is ensuring that the objectives and scope of the EDD focus the acquirer's investigation towards the right things in the first place. This is not helped by the fact that many EDD teams work without clear internal guidance and procedures:

- A quarter of companies interviewed do not have a standard procedure or guidelines for undertaking EDD.
- For those that do, many do not have a prepared generic list of important issues to cover – especially in Risk Category 2.
- A third of those with a generic list have not updated it within the last year, even in Risk Category 1 sectors.

Improving the management procedures and guidance in place around EDD appears to be a clear area of opportunity for many companies, and may come under increasing internal scrutiny as broader corporate governance reforms come into play.

Clarity of objective

The survey indicates that the approach many companies take to EDD has evolved beyond the traditional, relatively narrow confines of liability and compliance. But some have not, which indicates that companies are adopting diverse approaches to evaluating HSSE risk. To be complete, EDD should embrace a full range of business performance implications (financial and commercial considerations in particular), as well as the 'softer' but potentially key issues of brand and reputation:

- Half of companies which use EDD focus on technical environmental issues; the other half focuses on the implications of these issues to business performance.

All EDD exercises need to be undertaken with a clear aim to be able to inform the deal decision-makers of all business performance impacts, which could materially affect revenue, costs and liabilities, and any other issues which could impact the acquiring business itself – such as reputation and brand.

Deal rationale

The majority of companies appear to recognize that HSSE issues can affect the basic rationale of a transaction. But many do not formally review whether the HSSE findings have a significant impact on the drivers of (factors motivating) the transaction:

- Only 74 percent of Risk Category 1 companies evaluating EDD always assess the impact of HSSE issues on the deal, and only 57 percent of Risk Category 2 companies.

In some companies, EDD seems to be undertaken as a discrete, technical exercise. Leading companies have recognized that it is now necessary to take a more business and transaction oriented approach, and use tailored integrated EDD as part of the core transaction process.

Integrating findings into other work stream assessments

Some companies have not yet made the transition from a technically oriented to commercially oriented and integrated approach. The survey data indicates those adopting a technically oriented approach are much less likely to integrate their due diligence assessments. The danger of working in isolation is that some HSSE findings, which may not be material to the transaction when assessed in isolation, are significant when considered alongside financial, commercial or legal findings.

It is important for legal advisers, for example, to understand the HSSE findings so they can provide effective legal advice about them, and to help draft a sale and purchase agreement which takes the issues into account. A commercial due diligence adviser will also need access to the findings where market demand, customer, competitive position and operational issues are impacted by HSSE issues. And financial advisers will need to integrate financial consequences of what EDD has identified into their evaluation of projected costs and revenues, forecast cash flow, and the robustness of balance sheet liabilities and acquisition accounts.

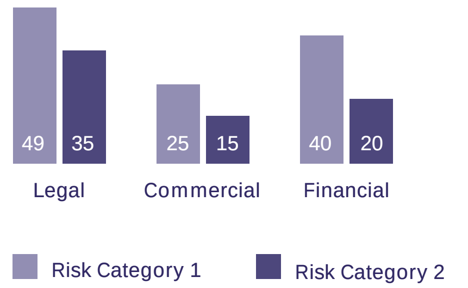
- Even in high-risk sectors, approximately half the companies do not share EDD findings with the legal team. Even more work in isolation from the commercial and financial teams.

Significantly, companies which share results with other work streams experience far fewer post transaction surprises. For example, 16 percent of companies which integrated EDD with commercial due diligence experienced post deal problems, compared to 37 percent of companies which do not integrate.

We found that all companies taking a business issue approach to scoping also integrate their EDD findings with the commercial and/or financial assessments (see Diagram 1). None of the companies taking a technical approach did so. Adopting a business approach is more likely to identify issues that are relevant to other work streams which may be why this is the case. The value of integration will be less obvious to those with a more technically orientated approach and reinforces the segregation that can undermine the value of EDD to some companies.

Diagram 1

Companies integrating EDD findings with other due diligence assessments (%)



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Emerging implications of HSSE issues

Broadening the scope

With regard to commercial and reputation or brand issues, the survey raises two key questions: do companies scope EDD to specifically investigate HSSE issues which could have commercial and brand or reputation impacts; and do companies assess the implications of their findings on business performance? The evidence from the research suggests that companies are more likely to assess the impact of issues that are identified in the normal scope, than tailor the scope to specifically look for potential issues. Scoping remains relatively narrow and technically orientated even when the assessment has been broadened to take into account a wider range of business performance issues.

EDD restricted to the traditional 'boundaries' may be dangerous. There are now many regulations, which are having wide-ranging impacts on business. For example, EU requirements for electrical waste (the WEEE Directive) and restricting the use of hazardous substances (known as ROHS) are essentially environmental laws but they will have wide-ranging business performance impacts. The immediate impact of these is that the WEEE Directive will introduce recycling obligations on manufacturers/producers, while the ROHS legislation will ban the use of certain substances in electrical and electronic equipment. The knock-on effects of these measures will be substantial and varied, for example:

- market opportunities for the collection of end-of-life equipment and for recycling facilities
- cost, cash flow and liability implications for WEEE manufacturers, with accounting implications for the balance sheet, working capital and profit and loss account
- market opportunity for material and component suppliers to deliver alternatives to conventional supplies.

The list could go on. What is clear is that business performance implications vary enormously and are dependent on the activities and market of the company under investigation.

Assessing commercial implications

We use the term 'commercial' to embrace significant market, customer, financing and operational impacts beyond the immediate technical and financial consequences of what the EDD identifies.

We asked companies about the commercial impacts of HSSE issues in these four areas:

- operational disruption
- competitive position
- demand for goods and services
- access to capital.

The research shows that many companies (see Diagram 2) do not investigate these kinds of HSSE consequences, but those that do frequently uncover material implications (see Diagram 3). While this may be partly because the issues are less relevant to some sectors, it suggests that those who do not could reap significant benefits by reviewing and updating their approach to EDD. In the cases of market demand and competitive position these companies are also potentially missing great opportunities.

Diagram 2

Proportion of companies not looking for HSSE implications in the four areas of commercial impact (%)

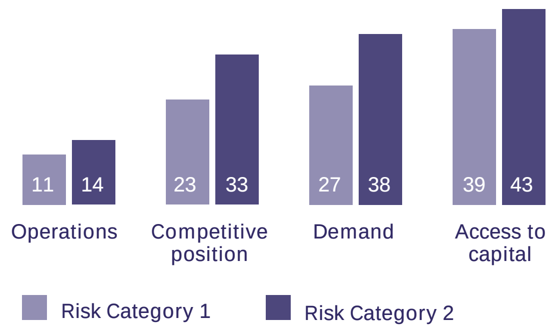

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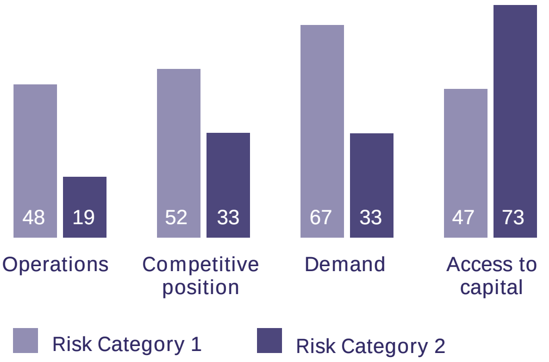
Diagram 3

Proportion of companies that have identified a material HSSE impact (%)



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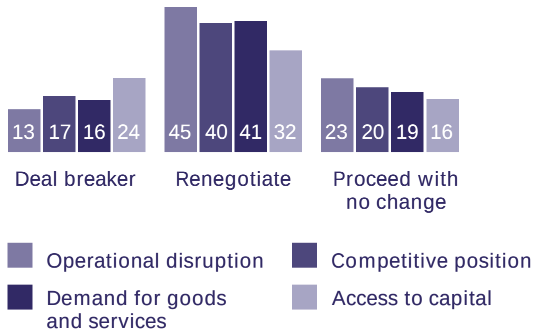
Companies that take the four commercial implications into account often find them to be material. In many cases, the discovery of significant consequences has led a company to abandon a deal, although re-negotiating the terms is a more common result (see Diagram 4). The fact that companies carried on with the original deal (without any amendments) in only a minority of cases demonstrates the risks being taken by companies not including these kinds of consideration in their EDD.

In addition to more negative issues identified, e.g. environmental costs and regulations, some companies found unexpected HSSE bonuses which made a deal more, rather than less, attractive. This is increasingly the case with market demand and customer relationship impacts.

Diagram 4

Effect of HSSE issues on the deal (%)



Additional option of 'other' result not included in these figures

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The types of HSSE issues identified by the interviewees were:

Operational disruption:

- inadequate social or community standards
- contaminated land
- HSSE upgrade requirements
- supply chain issues.

Competitive position:

- lower product recycling costs
- climate change and emissions trading
- meeting supply chain HSSE requirements.

Demand for goods and services:

- HSSE regulatory change (with positive and negative market impact)
- meeting supply chain HSSE requirements.

Access to capital:

- inadequate social or community standards
- contaminated land
- legal HSSE non-compliance
- industrial illness and disease claims.

Assessing implications for reputation and brand

The potential for reputation and brand damage is widely recognized; with only five percent of companies disagreeing that HSSE issues can have a material impact in this area. Interestingly, however, only 31 percent specifically scope the EDD to include all the HSSE issues which they think could have a material impact on reputation.

We found that almost half (46 percent) of those that undertake EDD were able to identify a situation where the target company's HSSE performance might have had a material impact on the aquirer's reputation. Issues arising included for example:

"Their safety records on environment and emission records were worse than ours so, at the end of the year, when the time comes to put the figures together it was going to make our figures look too bad."

"An acquisition was cancelled because it seemed too risky in the long-term. An example of this would be the risk of endless scandal for our group."

There is a significant difference in response between Risk Categories 1 and 2. Higher-risk companies are much more likely to find brand or reputation problems: 52 percent compared to just 22 percent for Risk Category 2 companies.

The impact of brand and reputation problems seems to be much more significant than other HSSE issues. In 30 percent of cases in Risk Category 1 and 25 percent of cases in Risk Category 2 where a material impact was identified, the transaction did not go ahead, emphasizing the significance of reputation to large European companies. More than a fifth of transactions went ahead with no change to the terms, but in many cases the reputation issues received immediate attention following the acquisition, to manage down the reputation risk exposure. Almost a fifth of the transactions were renegotiated.

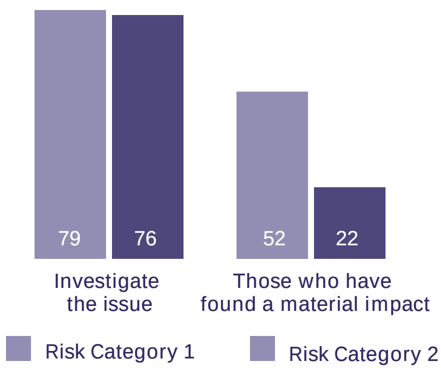
With regard to the type of HSSE issues that affect reputation and brand, some cases concerned community conflict, supply chain issues or an environmentally sensitive location, but the most common issues having a potential impact on reputation were:

- inadequate social/community standards (12 percent)
- legal non-compliance (nine percent)
- poor safety performance (nine percent)
- contaminated land (six percent).

It is worth emphasizing that the most common problem arising was a social rather than an environmental issue. Such issues may not be uncovered by an EDD exercise which is based on environmental specialists looking for conventional (technical) environmental issues.

Diagram 5

Reputation and brand implications (%)



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Conventional issues are still important

Contaminated land, effluent controls, compliance and other conventional environmental issues are still very important, and are likely to be central to the majority of EDD exercises. The research found that almost every company investigates regulatory compliance and contaminated land. Other risks, such as asbestos and waste management, are also often included automatically in EDD investigations. Conventional issues still often cause hiccups, or worse, as these managers explain:

“Effluent control wasn't there so we had to spend a fortune to comply with the usual environmental norms of our company.”

“We had exposed ourselves to a liability that we did not realize we had.”

“Soil pollution was so high and had such a bad impact that we pulled out of the transaction.”

“We realized that, because some of the products couldn’t be left in the open air, we would have to build a special storage unit, which would increase our costs. We therefore decided to renegotiate the price.”

The evolution of EDD cannot therefore be at the expense of investigating the traditional areas of risk. Robust technical skills remain as critical as ever to the identification and understanding of the consequence of HSSE issues. Ensuring the team has all the appropriate technical and jurisdictional knowledge, experience and access to the latest technical guidance is a key part of helping to ensure a successful outcome.

Agenda for action

The survey indicates that companies are adopting quite diverse approaches to their evaluation of HSSE risks on transactions, with varying degrees of success. Many companies may benefit from reviewing their approach to EDD, in light of the lessons and 'best practice' approaches emerging from the survey findings.

Companies reviewing their approach could start by asking the following questions:

Do you undertake EDD?

Do you have up-to-date internal EDD guidance and procedures?

Do you use EDD adviser selection criteria?

Do you consider a broad range of business performance implications (see below) when scoping the technical investigations?

Do you assess the business performance implications (see below) of the technical findings?

The types of business performance issues that may come up:

- operational disruption
- competitive position
- demand for goods/services
- access to capital
- reputation/brand
- legal compliance status
- management controls
- capital and operating expenditure
- liabilities and balance sheet implications
- cash flow forecasts.

Do you investigate social issues when the circumstances indicate it may be worthwhile (for example, when investigating exposure to reputation risk)?

Is the EDD scope of work discussed and shared with the following due diligence teams:

- legal
- commercial
- financial.

Are the EDD findings shared with the following teams:

- legal
- commercial
- financial.

Do you review the business performance implications in the context of the transaction drivers and assumptions?

Do you evaluate the EDD findings in the context of:

- deal breakers
- valuation model and assumptions
- sale and purchase agreement
- acquisition accounts
- post-acquisition actions
- exit strategy (if applicable)

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KPMG *Environmental Due Diligence* May 2004

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No: 208-251