

The Value of Integrated Due Diligence

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In today's M&A environment, the competitive challenges of finding the right transaction opportunities and effectively assessing their benefits and risks can be considerable. These challenges have only increased now that best practices in transactional due diligence have expanded beyond traditional environmental studies to include areas such as operational risk and product safety.

Most companies that acquire chemical and energy assets are well aware of the importance of assessing environmental, health and safety (EHS) compliance risks as an essential part of the due diligence process. Environmental risks have been well defined and generally applied in chemical and energy deals for many decades. However, in a growing number of transactions, two other areas have recently moved from the periphery of risk analysis to become critical topics of EHS due diligence:

- **Operational Risk (OR)** addresses the process safety aspects of operating units, helping to control the likelihood of incidents that may present hazards to property and personnel or threats to asset capacity and reliability.
- **Product Safety (PS)** deals with the management of chemical hazards that can impact current compliance, future product regulation, legal liability exposure, and the ability to continue to market specific chemicals.

Delivering Risk Intelligence

Until recently, considering all these factors within a due diligence assessment required the use of multiple providers. This has led to the development of an approach we call **Integrated Due Diligence (IDD)** — the use of advisory expertise and review methods that can deliver the full risk intelligence needed to produce a complete due diligence in the chemical and energy space.

So what elements are necessary to provide IDD? To be truly effective, an assessment must determine two

directionally opposite vectors: the negative vector of the full spectrum of EHS risk findings and the positive vector of using this risk information to advantage within the transaction. The IDD advisory approach creates a view of a chemical or energy business that is fully integrated in these two distinct dimensions:

- It is integrated **functionally** in that it can consider any number of technical risk areas—including environmental safety, personnel safety, process safety and product safety—within a single deliverable package.
- It is integrated with respect to **risk application** in that key findings can be characterized as both downside risk avoidance and deal relevance—that is, the advice and ability to use data to create potential advantage within the transaction. We use the term “risk intelligence” to describe this value-based advisory approach.

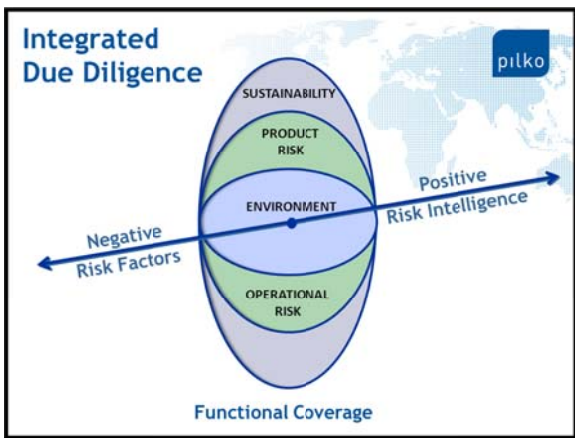
A Multi-Dimensional View

The first multi-dimensional factor of IDD is how the range of risk functions are addressed. A strictly defined environmental Phase 1 study may meet minimum lender requirements, but depending on the risk factors of a given transaction, may yield only a very monochromatic view of the total EHS risks. Increasingly, the most relevant risk factors that influence the post-transaction success of a deal may be related to operational or product risks in addition to environmental risk factors.

During a recent transaction best practices event, one of our prospective clients related a story of a deal they completed several years earlier. The client knew that differences existed between the target's operational standards and their own very demanding operational disciplines. But despite this discrepancy, the due diligence process adhered to a primarily environmental protocol, as is common.

The client reasoned, “We’ll get to the operational differences just as soon as the deal is done.” As it turned out, the differences in operational standards, the **Delta-S**, were much greater than anticipated. The client found that they had grossly underestimated how much capital it would take to bring the target facilities “up to speed.” As a result, precious capital reserved for cost and capacity improvements was consumed and the goals of the acquisition were delayed by more than two years—not a way to please the CEO!

Functional risk areas can be handled in separate analyses, but a fragmented assessment carries the danger of missing any potential interactions between disparate findings. Many clients have learned that the **interactions** between functional findings were the dominant aspects of the analysis instead of any one independent factor. Those interactions tend to go unnoticed if the analysis is performed by separate resources.



Conventional EHS due diligence is one-dimensional, focusing only on narrowly defined environmental issues that can have negative impact. In contrast, **Integrated Due Diligence (IDD)** broadens the scope of the inquiry to include other non-traditional environmental-related areas including operational and product risk, thus providing a more complete EHS risk profile for decision-making. Furthermore, conventional due diligence focuses on EHS issues as problems, or value detractors; IDD actually provides information about EHS-related value enhancers that might otherwise be overlooked.

Some clients rely on “in-house” expertise to perform the other functional reviews. Involvement of client experts may have positive aspects, but dividing the analysis in this way presents the same disadvantages noted above. Moreover, the assessment of multi-functional risks in a single due diligence effort performed by a single team of experienced advisors is generally more cost-effective than covering functional areas in separate analyses—even when in-house resources are used.

Turning Data into Insights

So what other aspect of IDD is important? Let’s step back for a moment. A prevailing view defines due diligence as a very important search for negative risk factors within a business or operating units pertaining to a transaction. This is, of course, an essential truth. Every company that acquires or sells chemical or energy assets must achieve an understanding of the pitfalls that these negative risk factors represent. But it’s not the whole truth.

The complete job of due diligence is not only about determining negative risk, but also about defining how the understanding of risk information can provide a buyer or a seller with an important deal insight or advantage—in other words, obtaining positive risk intelligence. Most providers of environmental assessments can produce a technical report (sometimes called the Phase 1 study) that may dedicate 50 to 100 pages to listing environmental (and sometimes safety) findings. These findings are often determined by technical analysts who, although skilled and technically capable, may not be sufficiently experienced to provide a characterization of what their data mean within the context of the deal.

Experienced advisors—those who have been inside multiple deal environments—can complete the full task of due diligence by classifying and translating the raw data into insights that become immediately understandable and useful to deal leaders and teams. It is generally just these insights that can not only help a deal team avoid pitfalls but also contribute to substantial monetary advantages for the total transaction effort.



For example, another client, a financial buyer pursuing a single asset from a strategic seller, utilized an integrated approach using our advisory experience to its fullest extent. The strict environmental review yielded a hazardous waste issue that seemed to be solved by the seller's use of a recycle interpretation. Integrated analysis, however, yielded a similar experience in which the recycle exemption was negated by the loss of several other operational factors. Further due diligence showed that this condition was also a factor in our client's transaction.

As this issue was developed to its true risk aspect, further negotiations reduced the purchase price to a level that dwarfed the cost of the additional diligence employed. Not only were the client and lenders pleased by the new price, they also realized that they had avoided a significant potential for Day One legal problems.

Pilko & Associates provides advice on the complete suite of operational, environmental and product risk aspects that are material to mergers, acquisitions and other transactions of chemicals and energy industries. Pilko has developed techniques and methodology and employs them to deliver the maximum amount of actionable deal intelligence within a given transaction's constraints, running the spectrum from formal data room review combined with operational site visits to low visibility Remote Sensing[®] that is used before actual deal activity or even target awareness. Pilko advisors have, on average, 34 years of real-world chemical and energy transaction experience, a qualification that is unparalleled.

If you would like more information on this topic or regarding Pilko & Associates' services and capabilities, please contact:

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