

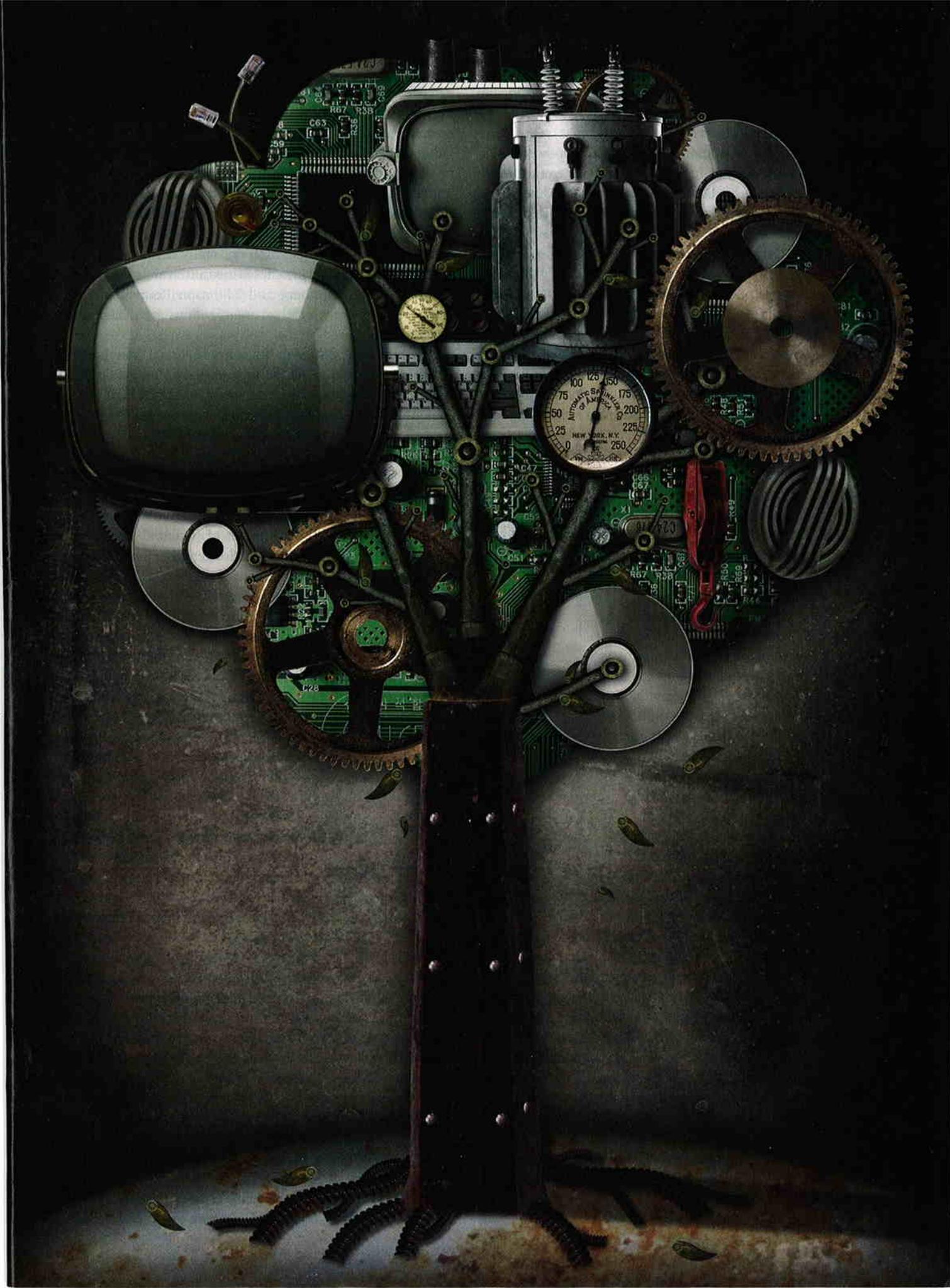
THE COST OF CLEAN

by MATT MILLER

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DEALMAKERS HAVE BEGUN
TO TRY TO FACTOR THE
ENVIRONMENTAL UPSIDE
AND DOWNSIDE INTO
M&A DUE DILIGENCE.

IT'S EARLY YET,
BUT THIS IS MORE THAN JUST
A BIRDS AND BUNNIES REPORT



WHEN PRIVATE EQUITY GIANT CARLYLE GROUP LAST MONTH announced a new environmental screen for acquisition due diligence, the move had public relations exercise written all over it. After all, going green can easily come off as one of those fuzzy, do-good efforts long on rhetoric, desperately short on substance. Corporate sustainability reports, for example, are often slammed as "the birds and bunnies reports," acknowledges Michael Krzus, a public policy partner at accounting firm Grant Thornton LLP.

Dismissing Carlyle's efforts, however, misses a powerful, although largely subterranean, current coursing through the M&A landscape. Environmental due diligence looks likely to become a vital part of the acquisition process. This isn't a question of scoring PR points. Nor is it merely identifying traditional environmental costs such as contaminated soil, pollution-spewing smokestacks or asbestos-laden pipes. Instead, an environment-related checklist can be used to identify both potential pitfalls and hidden benefits. Each has a significant impact on value.

"It may not be a liability now, but it will be a liability in the future. It may not be an asset now, but it will be an asset later," says Susan Mac Cormac, San Francisco-based co-head of Morrison & Foerster LLP's cleantech practice. "Environmental due diligence has fundamentally changed over the past three or four years."

Advocates maintain that a focus on environmental considerations means more than just doing one's part in cleaning up the planet but can translate into significant cost-cutting and revenue growth. "It is time to move beyond risk mitigation," says Thomas Murray, who heads the corporate sponsorship program for the Environmental Defense Fund. "Better environmental management and innovation drive increased efficiency, cost savings and more profitable operations."

Carlyle worked with the EDF and consultancy the Payne Firm Inc. to develop its environmental screen.

Growing awareness doesn't necessarily translate into overnight change, however, especially in deals with an environment-related focus. With promises of huge future growth, cleantech may have buzz these days, but little M&A action. "I just don't see utilities or big-scale businesses buying cleantech yet," says one venture capitalist who specializes in green technologies.

So far, an environmental calculus varies considerably from one business to another, even among those who are becoming accustomed to its use. Formulas are often broadly defined and can be captive to all sorts of subjective criteria, including basic environmental philosophy.

That squishiness will change. Expect a valuation metric in years ahead, most in the field believe, a kind of "green alpha." Such a metric could become as standardized as discounted cash flow or price-earnings ratios, predicts Joseph Keefe, president and CEO of socially responsible mutual funds manager Pax World Management LLC. "A lot of people are working on it," he says, "although we're not there yet."

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These new tools will likely measure positive and negative environmental factors, says Mike Wallace, a director at the Amsterdam-based Global Reporting Initiative, or GRI, which fashions sustainability reporting guidelines. They will mark another way to assess competitive advantage.

Part and parcel of this is the growing use of sustainability reporting, which GRI and others have constructed to combine environmental and social measurements with economic performance. That's at the heart of what's generally described as nonfinancial reporting, which is usually defined as environmental, social and governance issues, often shortened to ESG. Already, both Bloomberg and Thomson Reuters offer ESG performance screens. Other organizations are devising their own packages.

In the future, national, if not international, standards will dictate sustainability measurements, says Cindy Cahill, who heads climate change and sustainability issues in Britain for Deloitte LLP. "The time will come when you will be able to quantify all this," Cahill says.

Krzus, for one, believes some kind of international standards will become operative within the next five years.

Even without standards, advocates say, a growing number of potential acquirers understand it's no longer enough to merely run the financial numbers of a target. "There's a broader approach to risk review that now involves environmental, political, sustainability issues," says Alyson Warhurst, whose Bath, U.K.-based risk analysis firm Maplecroft both fashions screens and advises corporations.

For some environmental advocates, a well-defined environmental policy can serve as a proxy for good management in general. "For due diligence to ignore this is a glaring oversight," says Keefe. "A company that has developed a strong reputation in ESG is going to be a strong acquisition target."

Investor oversight is also part of the equation. Once the exclusive purview of socially responsible funds such as Pax World, investor concern about environmental practices now reaches large European pension funds and the giant California Public Employees' Retirement System.

This isn't merely high-minded idealism. "Sustainability is understood as a financial as well as a social concept," Keefe says.

In terms of regulations and constraints, it's more than just the state of play today. Environmental due diligence must take an educated guess at what a future world will look like. "Increasingly, clients are asking not so much about what current regulatory obligations are, but what they will be in the future," says Adam Kahn, a Boston-based environmental attorney who also serves as co-managing partner at Foley Hoag LLP. "On a number of acquisitions I've worked on in the past year or two, my clients have queried environmental liabilities, and they always question what will happen next."

By definition, knowing that future is a far more difficult challenge. "What is the level of lead in the soil? That's easy to measure," says Edward Witte, a Milwaukee-based environmental

attorney with Gonzalez Saggio and Harlan LLP. "Anticipating the onset of greenhouse gas restrictions—that's interpretive and intuitive."

The buyout of TXU Corp. (now known as Energy Future Holdings Corp.) is the best-known case of potential environmental regulations threatening a deal. In 2007, a consortium of Kohlberg Kravis Roberts & Co., Goldman Sachs Capital Partners and TPG Capital announced they would acquire the Dallas-based utility for a whopping \$45 billion. TXU, however, had run afoul of environmentalists with plans to build 11 coal-fired power plants. These carbon dioxide-belching plants are legal under current law but unlikely to pass muster in a greenhouse gas-restrictive environment. Environmentalists sued. After negotiations, the buyout consortium agreed to drop applications for the plants.

Corporations have been slow to acquire cleantech companies, though this year has seen a few cases of environment-related products and practices as the single-biggest determining factor in an acquisition decision. This doesn't just cover the usual suspects, say, a traditional power provider buying a wind turbine manufacturer, but companies in need of specific environmental-related technologies and processes using M&A. In May 2009, for example, the business management software behemoth SAP AG bought a privately held company called Clear Standards Inc., which developed software that measures and puts a dollar value on carbon dioxide emissions. Last month, Deloitte acquired carbon dioxide management and footprinting consultancy Dcarbon8.

Just how important a role environmental concerns play in an acquisition mix, of course, fluctuates widely, from critical to nonexistent. They're dependent on everything from product to geography. The European Union's environmental regulations, for example, are generally far more stringent than those found elsewhere. So the environmental component in European or cross-border deals involving Europe are likely to be more pronounced than one that's purely within American borders. "On the EU level, the debate over sustainability and climate change in reality is over," says Paul Sheridan, a London-based environmental lawyer with CMS Cameron McKenna LLP. "Europe is 10 years ahead of the States," he adds, listing everything from building regulations and energy efficiency to ecological product design and heat production. "If you can sell into Europe, you can sell anywhere in the world. That's not the inverse."

For U.S. companies, this can be both barrier and boost. Heather Austin, a Cleveland-based partner at Thompson Hine LLP, says she's working on a deal right now that involves chemicals banned in the EU but legal in the U.S. "You have to

be aware," she says. Austin adds that acquisitions of European chemicals companies by American concerns bring with them the added benefit of technology already implemented to reduce emissions. "That's an opportunity for a buyer," she says. "Before, I don't think anyone cared."

Some go even further. Sandip Sen is global head of alternative energy at Citigroup Inc. In energy and power generation arenas, he says, environmental considerations "have gone from due diligence to deal thesis, or at least a key ingredient in any deal's thesis."

NOT EVERYONE IS UPBEAT ABOUT ENVIRONMENTAL M&A ascendancy, especially after the failure last December at the Copenhagen global summit on climate change to mandate some kind of universal greenhouse gas-reduction target. That caused already-soft demand to drop even more for so-called carbon credits, which companies use to offset their own emissions. The price for one metric ton of carbon hovers at about €12.50 (\$16.72), according to the European Climate Exchange, far below what analysts believe is necessary to promote large-scale investments in clean technology.

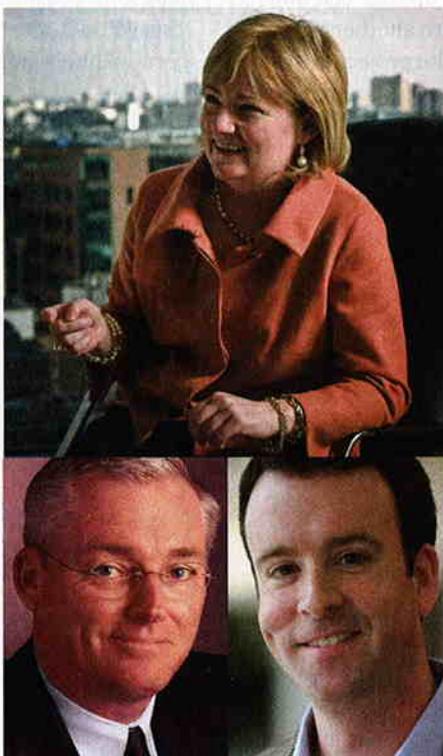
That, combined with Washington's inability to legislate carbon dioxide emissions regulations or even fashion an energy policy, has environmentalists fuming. The ascendancy of cleantech "doesn't happen through the market alone. We need incentives and good old-fashioned regulations," says Carter Bales, a longtime environmental advocate and corporate executive who last October co-founded NewWorld Capital Group LLC, a private equity group to invest specifically in midmarket cleantech-related companies and infrastructure projects. Bales adds: "Carbon has no value in a voluntary market."

While the White House and Congress have yet to tackle greenhouse gas emissions, some policy players are taking action on their own. They highlight the need to understand what's

coming. In January, the Securities and Exchange Commission mandated that corporations publicly report financial risks from environmentally destructive operations such as carbon dioxide emissions that may be circumscribed in the future. "The SEC guidance crossed the line from things that are in existence into those that are speculative," says Jane Luxton, a Washington-based partner at Pepper Hamilton LLP. "That's a big shock."

In fact, the SEC directive follows similar demands as far back as 2007 from New York Attorney General Andrew Cuomo that energy companies disclose greenhouse gas risks from coal-fired power plants.

However, most experts agree that the government trails private efforts to monitor corporate green quotients.



Cahill (top), Keefe (with glasses) and Murray
seeking green alpha

The methodology employed in the Carlyle screen provides a useful shorthand of broad-based environmental concerns and how they can be used in due diligence. According to the EDF's Murray, the screen identifies five broad-based issues: greenhouse gas emission, water use, waste management, forest products consumption and primary chemicals use. To arrive at their screen, the fund and the Payne Firm analyzed 327 current and former Carlyle portfolio companies. They came up with 10 categories of business activities with potential for both risk mitigation and, Murray stresses, cost savings and revenue expansion. The companies were evaluated not just for how well they were doing at the time, but for possible upside.

With this kind of guide, it's possible to assess environmental-related value in a target. That may be anything from waste heat recovery to changes in fuel mix.

The EDF will begin training Carlyle employees this month in its methodology, which will first be used on Carlyle's U.S. and European buyout funds. Carlyle is banking on an ability to quantify the dollar value of environmental upside. The fund is confident this is possible, given its work with another PE powerhouse, KKR. In 2008, the fund began a pilot project to identify operations in three KKR portfolio companies that could benefit from environmental tweaking. According to Murray, the exercise resulted during the first year in more than \$16 million in savings. The efforts reduced greenhouse gas emissions by 25,000 tons.

There is, in fact, precedence for a green acquisition premium. "In real estate, this is not a new phenomenon," says Gary Pivo, the director of the University of Arizona's Responsible Property Investment Center. In a study, Pivo found that investors on average will pay 50 basis points more for an energy-efficient building. In real estate, that translates into a cap rate that is one-half percentage point lower. Similar studies in California and Australia yielded the same results.

This makes sense, says Pivo, who also is a professor of urban planning. "A building with more efficient energy is less expensive to operate and has a higher net operating income." There are other benefits. A growing number of tenants will pay more for a green building. Pivo likened this to the 1980s, when buildings wired for computer access gained competitive advantage.

Some kind of environmental-related M&A due diligence has existed for the past quarter-century. Until recently, however, it's been simple, straightforward and wholly defensive. "These are issues of liability," says Mark Steger, a Chicago-based partner with Holland & Knight LLP. "Does the business have a problem? How much is this going to cost to fix?"

Sheridan describes these as "skeletons in the closet" and

adds, "That's a fairly well-trodden path."

Due diligence continues to be largely defensive but is growing in both complexity and focus. Nowhere is that more important than in climate change. "Environmental due diligence will be morphing over time as companies become more attuned to carbon emissions," says Steger.

That's happening in Europe, where the EU has pledged to slash carbon dioxide emissions 20% by 2020. How individual countries get there is a matter of approach and resolve. In March, the French government of Nicolas Sarkozy announced it wouldn't push through with plans to tax carbon dioxide, a move that brought a stinging rebuke from one of the government's own ministers.

ONE OF THE MOST AGGRESSIVE EUROPEAN COUNTRIES IS BRITAIN.

Any enterprise that spends more than £500,000 (\$745,000) a year on electricity will, beginning this month, be able to buy and sell carbon credits. From 2013, however, carbon dioxide emissions for these businesses will be capped. "If you get it right, it costs you nothing," says Deloitte's Cahill. "If you get it wrong, there will be significant fines, 3 or 4 times what carbon costs

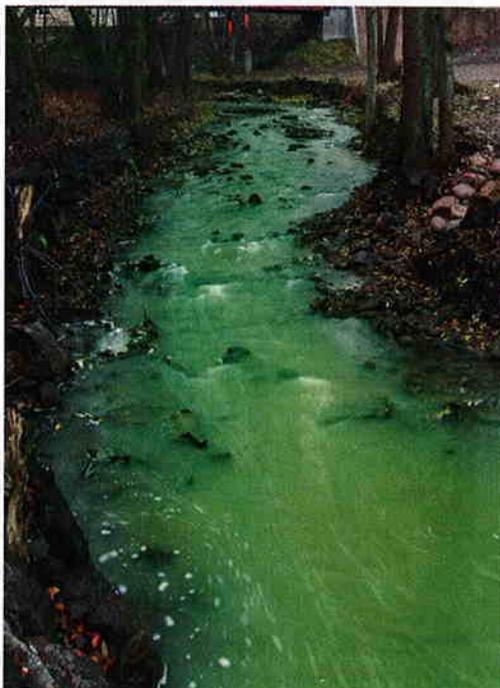
you." More to the point, she notes, that carbon equation will become part of a business' valuation. "You'll need to think about acquisitions in the future in terms of energy output or requirements. Once [carbon] goes into the open market, it becomes an additional cost.

Even skeptics in the U.S. believe that at some point carbon will be regulated. For the heaviest polluters, that means "billions of dollars in liabilities," says Morrison & Foerster's Mac Cormac. But tens of thousands of American businesses must also confront their carbon footprint. M&A will become part of the mix.

Mac Cormac, for one, predicts that at some point, corporations will go so far as to acquire other companies based on the carbon equation. "They'll buy companies about to go out of business, shut them down and take advantage of a lack of carbon emissions," she says. Carbon "becomes an asset in bankruptcy."

In the meantime, it's hard to say with any assuredness just how important environmental concerns play in current M&A transactions because the overall deal market has been so weak. As Gonzalez Saggio's Witte points out, the most popular model during this lean period has been the purchase of assets out of bankruptcy, "not necessarily the paradigm of due diligence."

But Witte, like others in the field, believes that as M&A activity increases, there will be a new emphasis on what he calls sustainability preparedness. "As we awaken from hibernation, the nature of transactional due diligence, the nature of environmental due diligence, will have changed." ■



River pollution toxic investment