

REACTION

Chemical Magazine / Tenth Edition

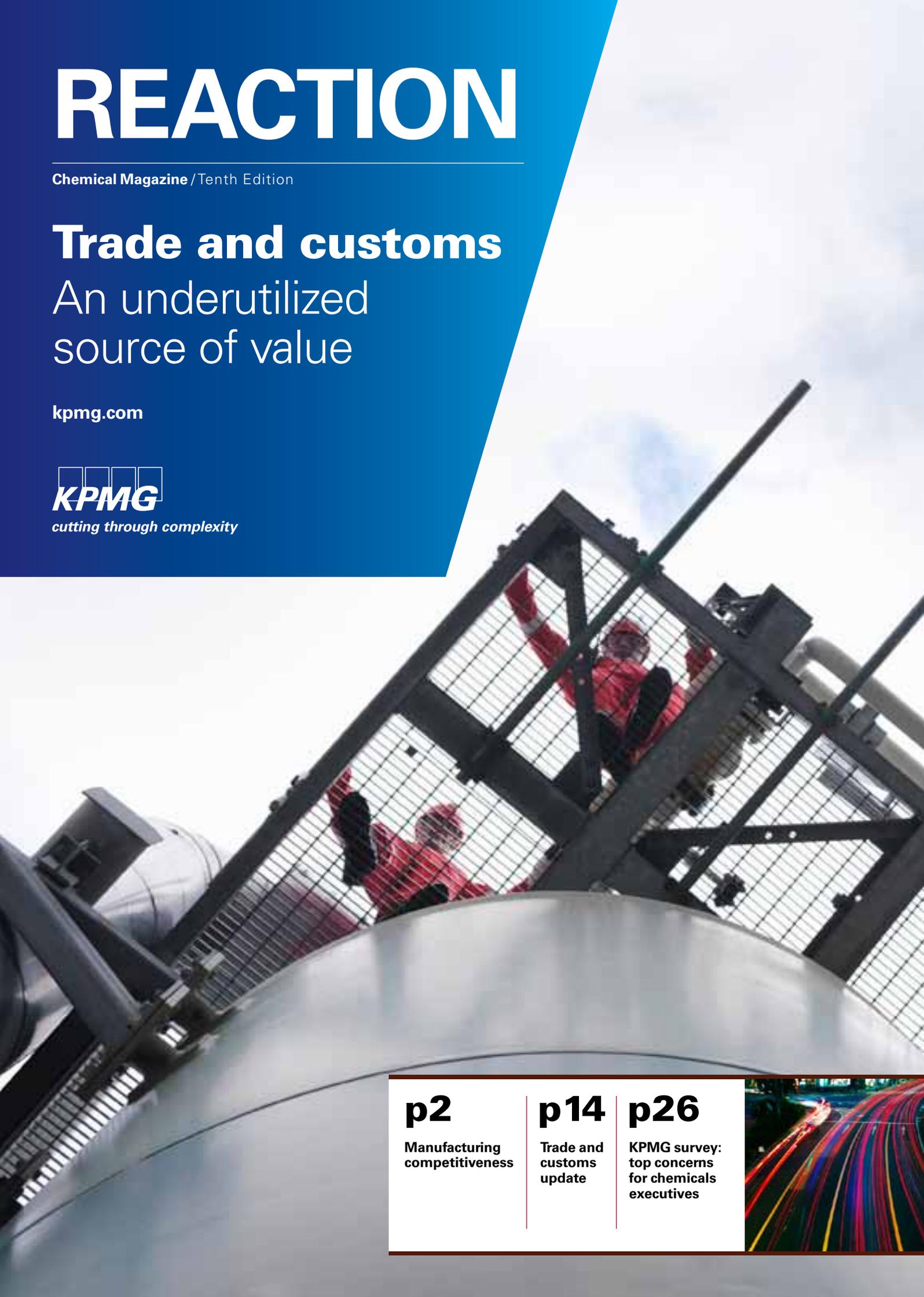
Trade and customs

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cutting through complexity



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Manufacturing competitiveness

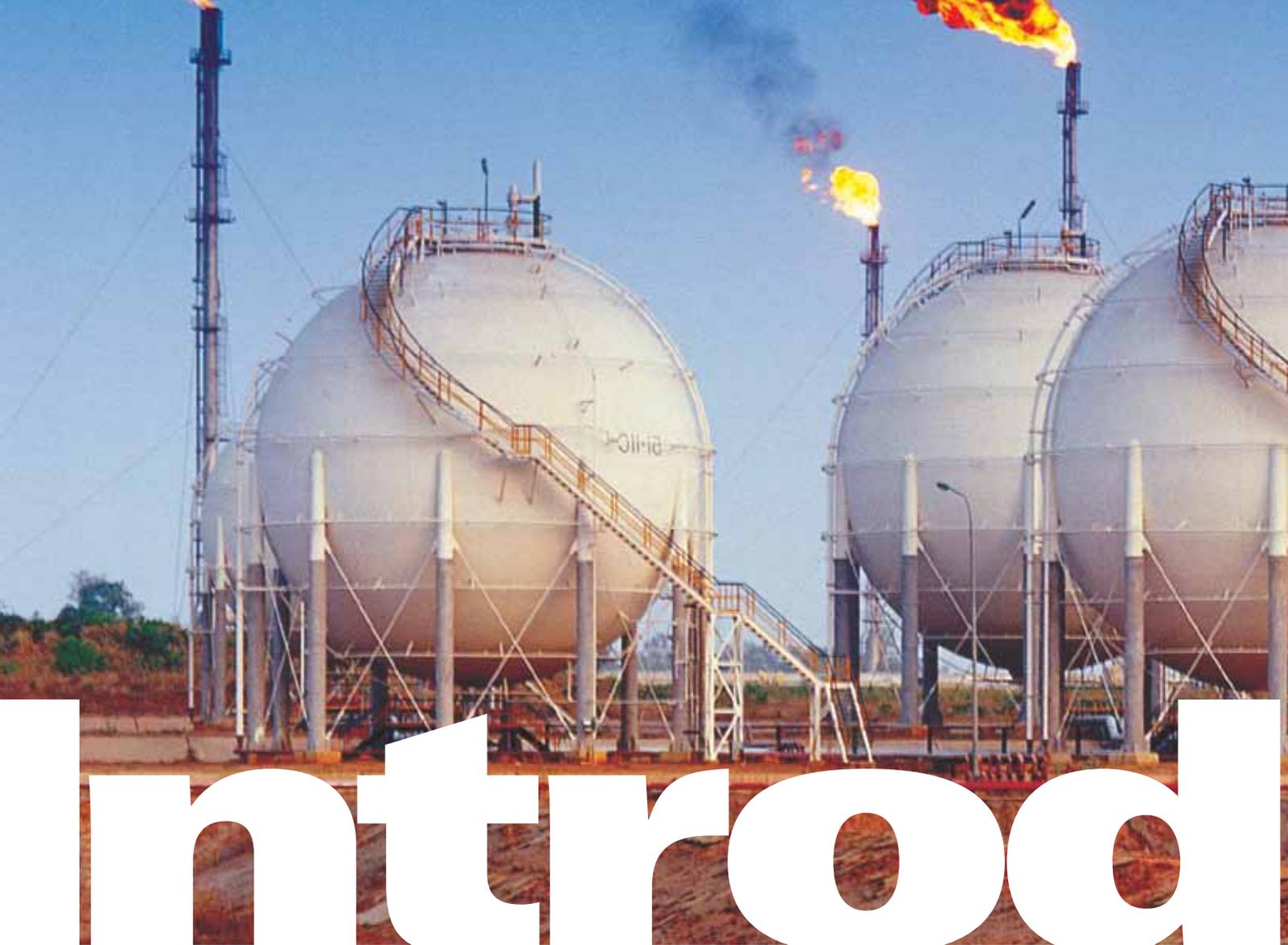
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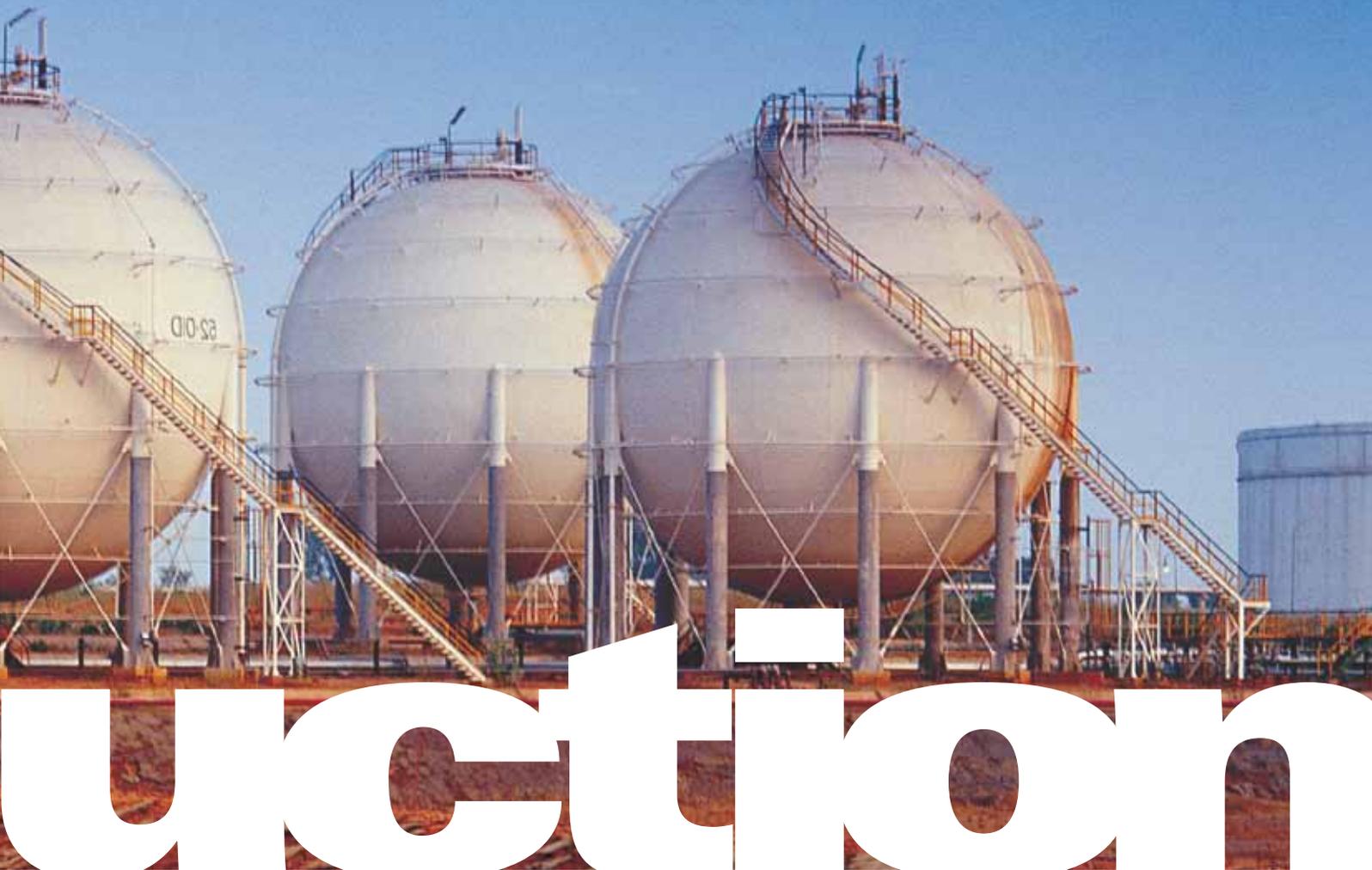
KPMG survey: top concerns for chemicals executives





Welcome to the latest edition of Reaction Magazine and the first one for 2013. It is looking like another uncertain year for the industry but at least the year has begun with a positive outcome to the US fiscal cliff negotiations (although much work remains with regards to addressing the deficit) and some positive signs emanating from China suggesting a return to more robust growth. Nevertheless, downside risks remain and the lack of growth prospects in Europe continues to be a concern for executives across the industry.

With that in mind, in this edition we focus on operational strategies to maximize internal efficiencies and drive cash generation. Specifically, we look at manufacturing excellence in Australia with a view on how best practice could be leveraged in other developed economies to deliver added value. We also focus on import taxes and duties – an often overlooked area where companies can recognize significant cash tax savings.



As ever, we continue to be active in the industry, and look forward to seeing many of you at the KPMG-sponsored CFO roundtable discussion in New York in June 2013.

We will be back with our next edition in June, which will take a close look at the outlook for the chemical industry in Europe and discuss the strategies that global chemical companies will need to implement in order to be successful in the years ahead. If there are any other topics you would like us to cover in future editions of Reaction Magazine, please do not hesitate to contact us.



Mike Shannon

Global Chair
Chemicals and Performance
Technologies

Australian chemicals: a case study for High Value Manufacturing

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Guarded optimism for the future

Australian chemicals:
a case study for

HIGH VALUE MANUFACTURING

by

Steve Tonner

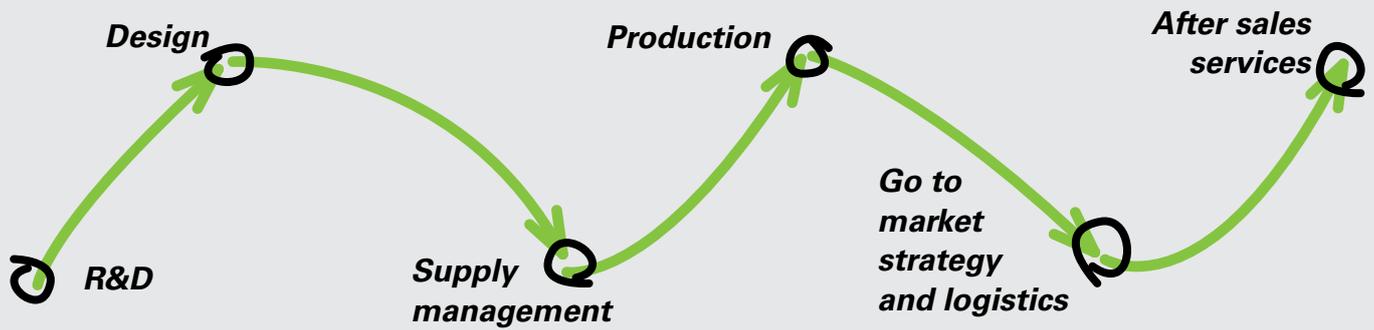
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Manufacturers in developed economies face ever-increasing competition from their counterparts in emerging markets where many costs are lower. This fact is especially true for the global chemical industry. To remain competitive, chemical manufacturers in developed countries are redefining manufacturing as more than just production. The Australian chemical industry provides a case study in how a holistic understanding of High Value Manufacturing can help increase the competitive edge of high-cost chemical manufacturers and provide an effective strategy for long-term domestic and international growth.

Manufacturing Value Chain



Source: Rationales for industrial policy based on industry maturity; Finbarr Livesay; Centre for Industry and Government working paper 2010/11

Traditional thinking about manufacturing is often focused on production, specific industries or even certain products, but in a global economy, that thinking needs to change. Today's manufacturing is evolving into a complex ecosystem that includes various industries, government policies, regulations, and customer markets at home and abroad.

As such, industry leaders need a more holistic view of manufacturing that involves the entire value chain, from research and development (R&D) and design to supply management, production, go-to-market strategies, logistics and after-sales services.

In the same way, manufacturing competitiveness must be understood

as the result of key influencers such as government policies, taxes, regulations, energy and feedstock sources, regional infrastructure, logistics support and other factors.

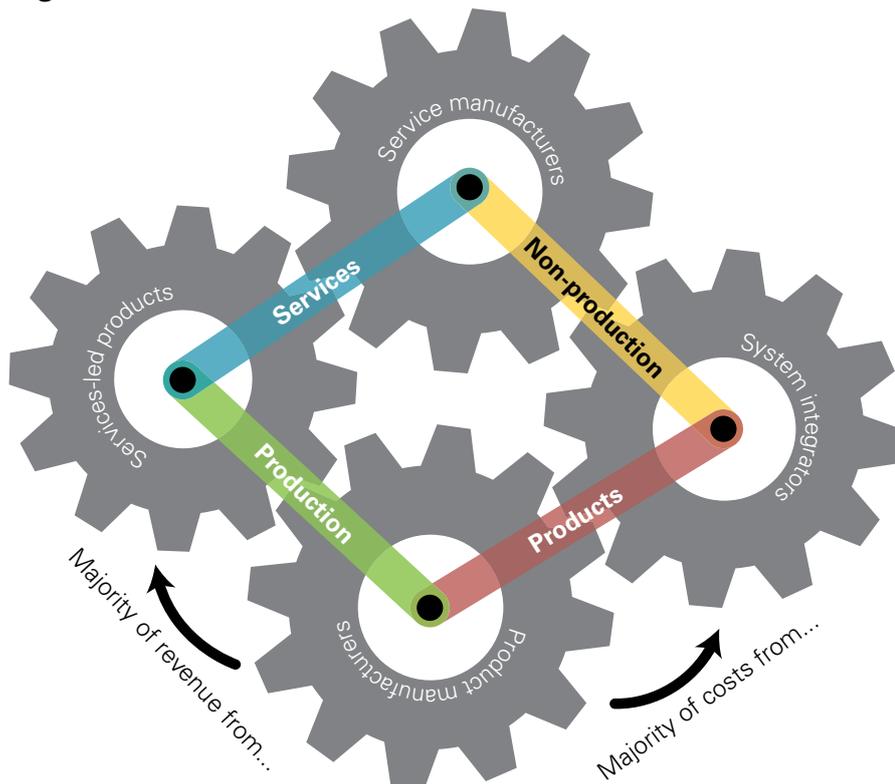
Finally, both government and industry need to keep in mind that overdependence on one industry can be dangerous, as the recent global downturn has shown in economies around the world. Accordingly, each country needs to create a comprehensive strategy for manufacturing by identifying which industries are key to the country and helping to ensure that these industries remain a vital and growing part of the economy.



Source: KPMG International, 2013

» The High Value Manufacturing model

High Value Manufacturers



Source: *Defining High Value manufacturing*, Finbarr Livesey; Institute for Manufacturing, University of Cambridge; January 2006

The High Value Manufacturing model acknowledges the essential interdependence of production and services. Based on revenues and costs, four business areas can be identified:

- **Services-led producers**, providing customers with services based on considerable production capability
- **Product manufacturers**, focusing on value generated solely through production
- **Service manufacturers**, generating value from services that support a product

- **System integrators**, controlling the channel to customers and managing an external production network.

As this model suggests, manufacturers are not limited to production in terms of adding value through their supply chain. For example, the Dow Chemical Corporation is a highly successful major product manufacturer with more than 5,000 chemical, advanced materials, agrosociences and plastics products. At the same time, the company also generates substantial value through non-production areas such as R&D, marketing and distribution.

The High Value Manufacturing model acknowledges the essential interdependence of production and services.



In Australia, agricultural chemical manufacturers also add value through innovative delivery systems and packaging, as well as distribution networks that ensure that products reach a widely dispersed customer base. This approach complements and adds value to local manufacturing activities.

Along with the close relationship between production and services, the High Value Manufacturing model for chemicals requires a collaborative effort among various groups across the chemical industry, unions, academia and government. Accordingly, government policies, analysis, and

industry-wide efforts should address the following objectives:

- Redefine manufacturing and consider how each element of the value chain impacts the competitiveness of the chemical manufacturing industry, from R&D and design to distribution and after-sales services.
- Understand the value of the chemical manufacturing industry in terms of national, social, organizational and employee issues.
- Prioritize all manufacturing industries and develop a tailored action plan according to their maturity and their comparative advantage in domestic and international markets.
- Develop strategic action plans and industry policy by proactively engaging industries which are impacted and which impact chemical manufacturing. This includes financial institutions, transportation, infrastructure, mining, retail, engineering, and educational institutions.

Manufacturing competitiveness in Australia

Australian chemicals¹

Represents **9% to 10%** of Australian manufacturing output

Inventory turnover:
US\$35.3 billion

Industry value-add:
US\$12 billion

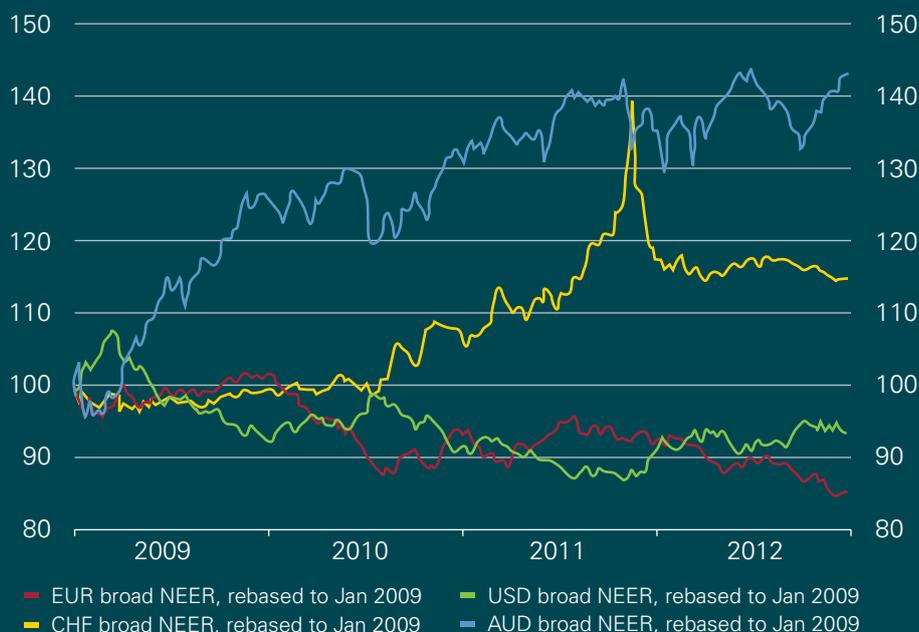
Direct employment:
approximately **83,000**

Generates approximately **0.6%** of global chemical sales and **0.85%** of global chemical trade

Supplies key products and raw materials to mining, agriculture, manufacturing, construction, public health and other sectors

The Australian chemical industry provides an excellent case study in how the High Value Manufacturing model can be applied in a developed economy. Although the Australian industry represents less than 1 percent of global sales and trade for chemicals, Australian manufacturers face many of the same issues found in developed countries worldwide. Lessons learned in Australia may very well be used in the future to enhance High Value Manufacturing in North America, Europe, Japan and other regions.

Nominal effective exchange rates (NEER) of the US dollar, euro, Swiss franc and Australian dollar²



¹ Data from *Plastics and Chemicals Industry Association*, www.pacia.org.au

² Weighted by trade partner but not adjusted for inflation. Cited in *Chart of the day: Nominal Effective Exchange Rates*, Marc Chandler, August 17, 2012

High energy and feedstock prices – a game changer

Although abundant domestic reserves of minerals, coal and natural gas have helped to mitigate the effects of the global economic downturn in Australia, the mining boom has created both opportunities and challenges for the domestic economy in general and the chemical industry in particular.

As noted in other countries, a sharp inflow of foreign currency from the exploitation of natural resources can result in “Dutch disease” – which is generally defined as a decline in a country’s manufacturing sector triggered by rising costs and a strong currency that hampers exports. In the case of Australia, a strong mining sector and a troubled global economic environment over the past several years have helped the country’s dollar to surge, encouraging a multi-speed economy and a decline in manufacturing activity, including specialty chemical and petrochemical manufacturing.

At the same time, liquefied natural gas (LNG) facilities are being constructed on the east coast to support export to Asian markets. This creates the risk of a shortage for competitively-priced energy and feedstocks used by Australian

manufacturers for basic chemicals, plastics, paints and other products. Current government policies are strongly in favor of gas exports, which are predicted to rise from 2 million tonnes in 2015 to 24 million tonnes in 2023³.

This situation has not gone unchallenged by industry groups. Margaret Donnan, chief executive for the Plastics and Chemicals Industries Association (PACIA) has noted, “The coming expansion of LNG exports from Australia’s east coast offers many benefits. But as the experience of Western Australia suggests ... the immense quantities contracted for export risk squeezing domestic consumption, and tie us to the East Asia gas market – the most expensive in the world”⁴.

In the US, the shale gas boom has lowered feedstock prices, increased energy independence and encouraged investments in the chemical sector. Australian chemical manufacturers are keeping a close watch on these developments as they consider what steps to take in terms of industry initiatives and future changes in government policies.

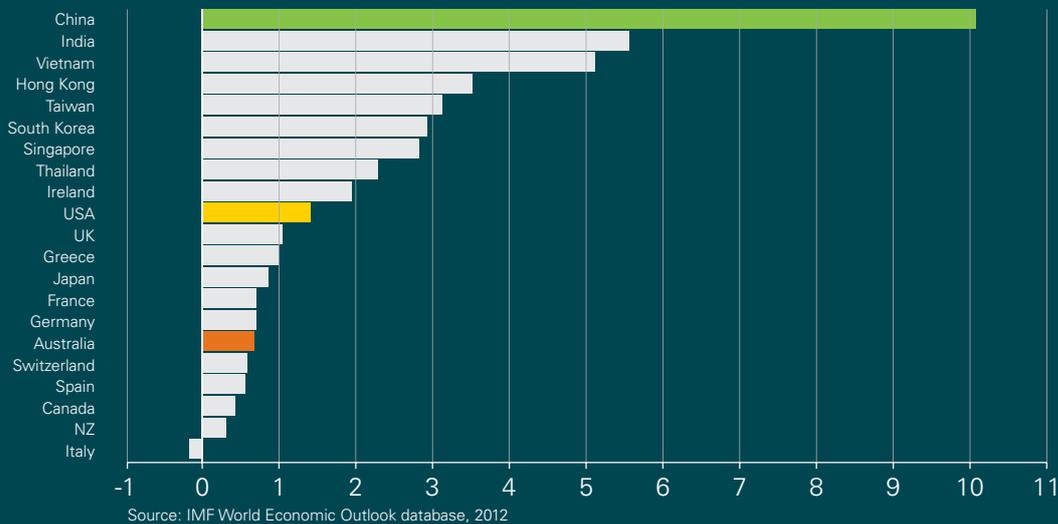
The coming expansion of **LNG exports** from **Australia’s east coast** offers many benefits. But as the experience of Western Australia suggests... the **immense quantities** contracted for export risk **squeezing domestic consumption**, and tie us to the **East Asia gas market** – the **most expensive in the world**.

³ *New Report Highlights Risks of Gas Export Boom*, press release, Australian Industry Group and the Plastics and Chemicals Industry Association, October 17, 2012

⁴ *Inquiry Needed to Fill Gas Gap*, press release, Australian Aluminium Council (AAC), the Australian Food and Grocery Council (AFGC), the Australian Industry Group (Ai Group), the Plastics and Chemicals Industries Association (PACIA) and The Australian Steel Institute, November 9, 2012

» Productivity – adapting to a challenging environment

Labor productivity: average annual real output per hour worked, in percent, 2002-2011



As the chart above illustrates, Australia lags in productivity compared with many of its overseas competitors, a fact made all the more worrisome in the face of the strong Australian dollar. The Australian government may want to consider a revised policy agenda across a number of portfolios, fostering funding that is sufficient to match stated policy goals. Areas of concern for the chemical industry include regulatory complexity across state and federal jurisdictions in the areas of labeling, dangerous goods

transportation and new chemical introduction. In addition, Australian businesses should implement strategies in the workplace to increase efficiencies and help drive down operating costs.

Equally important, Australian workers should be prepared to take up opportunities to improve skills and training throughout their careers and to match wage claims with improvements in productivity to foster long-term competitiveness across all sectors of the economy.



» Food security – growing opportunities

Australia is well positioned to take advantage of new and expanding food markets in Southeast Asia. A growing population in India, China and across Southeast Asia also includes a larger middle class that is shifting from a grain-based diet to a more Western diet of meat products, fish, dairy and fresh vegetables. The Australian Farm Institute estimates that by 2020, Asia will be importing an additional 5.2 million tonnes of dairy products, 1.9 million tonnes of beef and 1.1 million tonnes of chicken⁵.

To help capitalize on this significant market opportunity, Australian chemical manufacturers can provide products that enable Asian farmers to increase yields, preserve crops from pests, diseases and weeds, and take advantage of the latest developments in gene-splicing technology.

Another market involves water. Agriculture in Australia is characterized by periods of prolonged drought. The Australian chemical sector can provide technology to support the cultivation of hardy, drought-resistant crops appropriate for areas that are already experiencing higher temperatures and water scarcity.

⁵ *Food production in Australia, Final report, Australian Senate, August 2010*

» Adapting to change – innovation and restructuring

In Australia's multi-speed economy, chemical manufacturers can minimize activity in slow-growth markets such as automobiles while focusing on areas with more revenue potential, such as mining. For example, Orica has become the world's largest supplier of mining explosives through a process of organic growth, divestment, cost-cutting and restructuring⁶. In an attempt to capitalize on proximity to both feedstock and market, Orica has announced a joint venture of US\$843 million with Norway's Yara and US oil and gas company Apache. The companies plan to develop a 330,000 tonnes per annum (tpa) ammonium nitrate plant in the iron ore-rich Pilbara region of Western Australia⁷.

Global agricultural chemical manufacturers such as Bayer, Dow and BASF as well as Australia's Nufarm, have substantial investment in crop research in Australia, often in partnership with the government or universities. Globally, chemical industry participants such as DuPont, Syngenta and Monsanto have also invested strongly in crop research. Australia's unique environment – characterized by dry conditions with complex and sensitive ecosystems – will encourage continued innovation based on world-leading crop research and solutions.

Other companies have captured new markets by expanding their services. Campbell Brothers, a leading Australian soap and chemical manufacturer, has diversified into specialist testing and analytical laboratory services that support the mining and water treatment sectors⁸. Dulux Group has merged with CamelPaint, a Hong Kong paint maker, to capture part of the region's fastest-growing coatings markets.

The Australian mining industry has provided the local chemical industry with strong revenue and non-production opportunities, as the industry sheltered Australia from the worst of the financial turbulence over the last few years. In particular, mining has created significant demand for explosives and minerals extractions chemicals such as cyanide. The chemical industry has also provided other, non-production opportunities such as supporting R&D in Australia. Examples include the Cooperative Research Centre for Polymers, a body which is highly regarded in the international polymer science community, and the Centre for Green Chemistry at Monash University.

⁶ *Australian Chemicals*, IHS Chemical Week, June 25, 2012

⁷ Orica bets \$800million in the Pilbara, *Australian Financial Review*, 22 May 2012

⁸ www.campbell.com.au





» Next steps for high-cost chemical manufacturers

According to an April 2012 report by the International Monetary Fund, Australia will be the best performing major advanced economy in the world over the next 2 years⁹. GNP growth is estimated at 3 percent or greater until at least 2017¹⁰. The Australian chemical industry can keep pace with this growth with High Value Manufacturing supported by the following initiatives:

- Proposing a framework for broader industry and government engagement in identifying opportunities for Australian chemical manufacturers.
- Developing along with other industries a more proactive and collaborative plan to transition Australia to a high value manufacturing economy.
- Assisting the government in identifying practical solutions to attract investment, stimulate productivity, reduce the cost of doing business and increase access to growth markets.

» According to an April 2012 report by the International Monetary Fund, Australia will be the **best performing major advanced economy** in the world over the **next 2 years**.

⁹ *World Economic Outlook (WEO): Growth Resuming, Dangers Remain*, IMF, April 2012

¹⁰ *Ibid.*



Lessons learned

Australia can serve as a valuable model for both developed economies facing similar challenges and developing countries as they look to build their chemical industries.

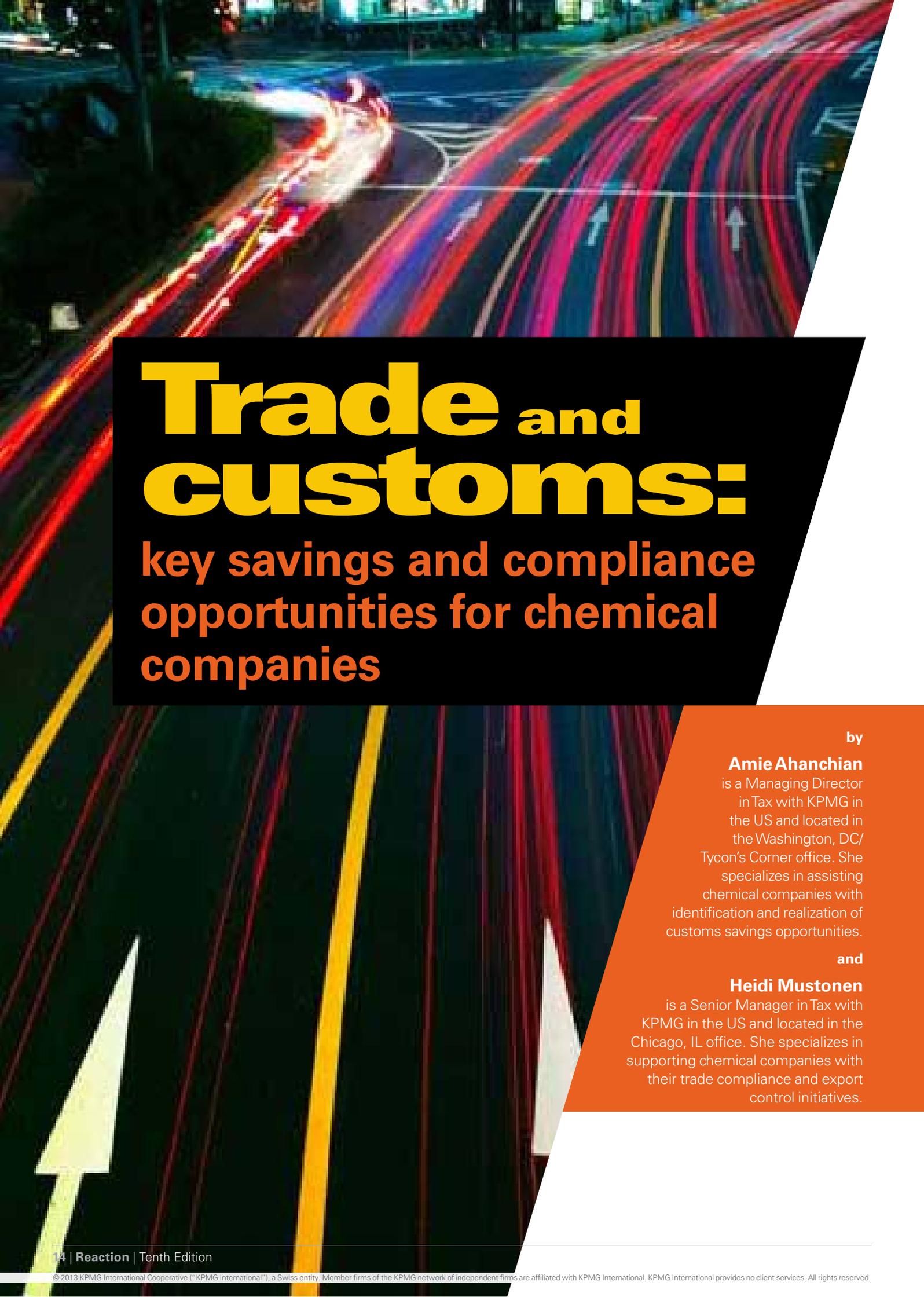
In both cases, players in chemical industries need to identify and prioritize opportunities in the local market to drive revenues, innovation and other key factors in business success. They should also maintain a focus on non-production initiatives to drive more efficient cost-structures and services. In the same way, R&D can be used as a platform to develop more advanced products that suit local markets and potentially other markets around the world.

Since energy feedstocks are critical to the development of any chemical industry, an

energy strategy at a company and country level is important to maintain and develop the industry. Productivity advancement is also essential to maintain global competitiveness.

Finally, industry experience in Australia shows that regulations should be developed and applied across states or provinces in a consistent fashion, helping to support the movement of goods without creating unnecessary complications or red tape.

With these and other measures, chemical manufacturers can maintain their competitive position and help drive their long-term growth in the global economy.

A long-exposure photograph of a city street at night, showing vibrant light trails from cars in shades of red, orange, and yellow. The street has white lane markings and arrows. The background shows blurred city lights and buildings.

Trade and customs: key savings and compliance opportunities for chemical companies

by

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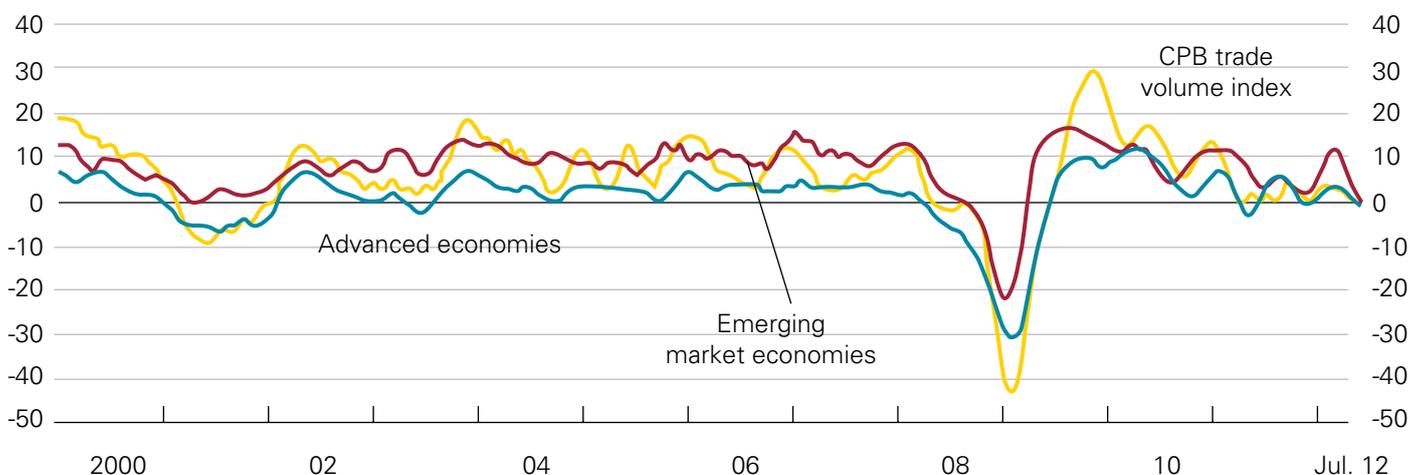
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In these times, multinational companies are challenged with the prospect of another year of uncertain recovery in the worldwide economy. To proceed confidently in the area of global commerce, many chemical companies are identifying more ways to reduce customs duty costs, streamline international trade operations and enter new and emerging markets. Additionally, companies are closely monitoring recent developments in trade relations, sanctions and export controls that could have a significant impact on global chemicals trade throughout the year.

Industrial production and world trade

(annualized percent change of 3 month moving average over previous 3 month moving average)



Source: *World Economic Outlook*, IMF, October 2012

According to the OECD's latest *Economic Outlook* issued in December of 2012, the GDP growth for OECD countries in 2013 is expected to remain low at 1.4 percent and increase to only 2.3 percent in 2014. As summarized by OECD Secretary General Angel Gurría, "The world economy is far from being out of the woods."

Even when the rapidly growing economies in Asia are included, expectations for 2013 remain modest, according to most observers. The United Nations report *World Economic Situation and Prospects 2013* forecasts world economic growth of only 2.4 percent in 2013 and 3.2 percent in 2014, a significant downgrade from forecasts made in the middle of 2012.¹ From 2013 to 2025, emerging and developing

countries are projected to grow at 3.3 percent, according to The Conference Board².

In light of these conditions, cost and performance enhancement by businesses is more important than ever. Accordingly, many multinational chemical companies are taking a strategic approach to trade and customs issues to help decrease their overhead, improve their supply chains; increase cash flow and better position themselves for today's uncertain economy and changing regulatory environment.

This article provides a snapshot of important trade and customs considerations, opportunities and challenges for chemical companies.

¹ *Global economic outlook for 2013 revealed*, press release, United Nations, December 17, 2012. Accessed at www.un.org/en/development/desa/news/policy/wesp2013

² *Global Economic Outlook*, The Conference Board, accessed at <http://www.conference-board.org/data/globaloutlook.cfm>

Free Trade Zones

The **chemicals FTZ manufacturer** has the opportunity to **select the duty rate** applicable to the finished product when it is shipped from the FTZ into the **US customs territory**.

Multinational chemical companies can often gain significant advantages using Free Trade Zones (FTZs)³. These zones are designated areas that provide multinational companies conducting import operations with savings opportunities for customs tariffs as well as flexibility in terms of inventory management and regulatory requirements. Many FTZs also offer ready access to port facilities, warehousing and other infrastructure. In the US, chemical companies that operate in FTZs may realize the following customs savings opportunities:

- **Inverted Tariff Savings:** The “inverted tariff benefit” refers to an imported FTZ duty savings benefit for chemical manufacturers which potentially exists when certain finished chemical and petrochemical products are made at a US facility from foreign-sourced technical ingredients and raw material inputs that are dutiable upon importation. If the finished chemical product would have a lower duty rate when imported directly into the United States (as compared to the duty rate

for the imported ingredients from which it is made), the chemicals FTZ manufacturer has the opportunity to select the duty rate applicable to the finished product when it is shipped from the FTZ into the US customs territory. The selection of the finished-product duty rate enables the manufacturer to benefit from the inverted tariff mechanism, thereby reducing or eliminating duties on the foreign sourced components.

Companies in the petrochemical, pharmaceutical, vitamin, agricultural protection, animal health, and silicon-based product manufacturing sectors may benefit from the inverted tariff mechanism. Here is an example for certain silicon-based products:

- Foreign sourced inputs (isododecane, carbon dioxide liquid, magnesium sulfate, glycerine, methyl ethyl, etc.): Duty range of 0 percent to 7 percent
- Finished silicon-based products: Duty range of 0 percent to 6.5 percent

When the finished silicon-based products are shipped from the zone

The **selection of the finished-product** duty rate enables the manufacturer to benefit from the inverted tariff mechanism, thereby **reducing or eliminating duties** on the foreign sourced components.

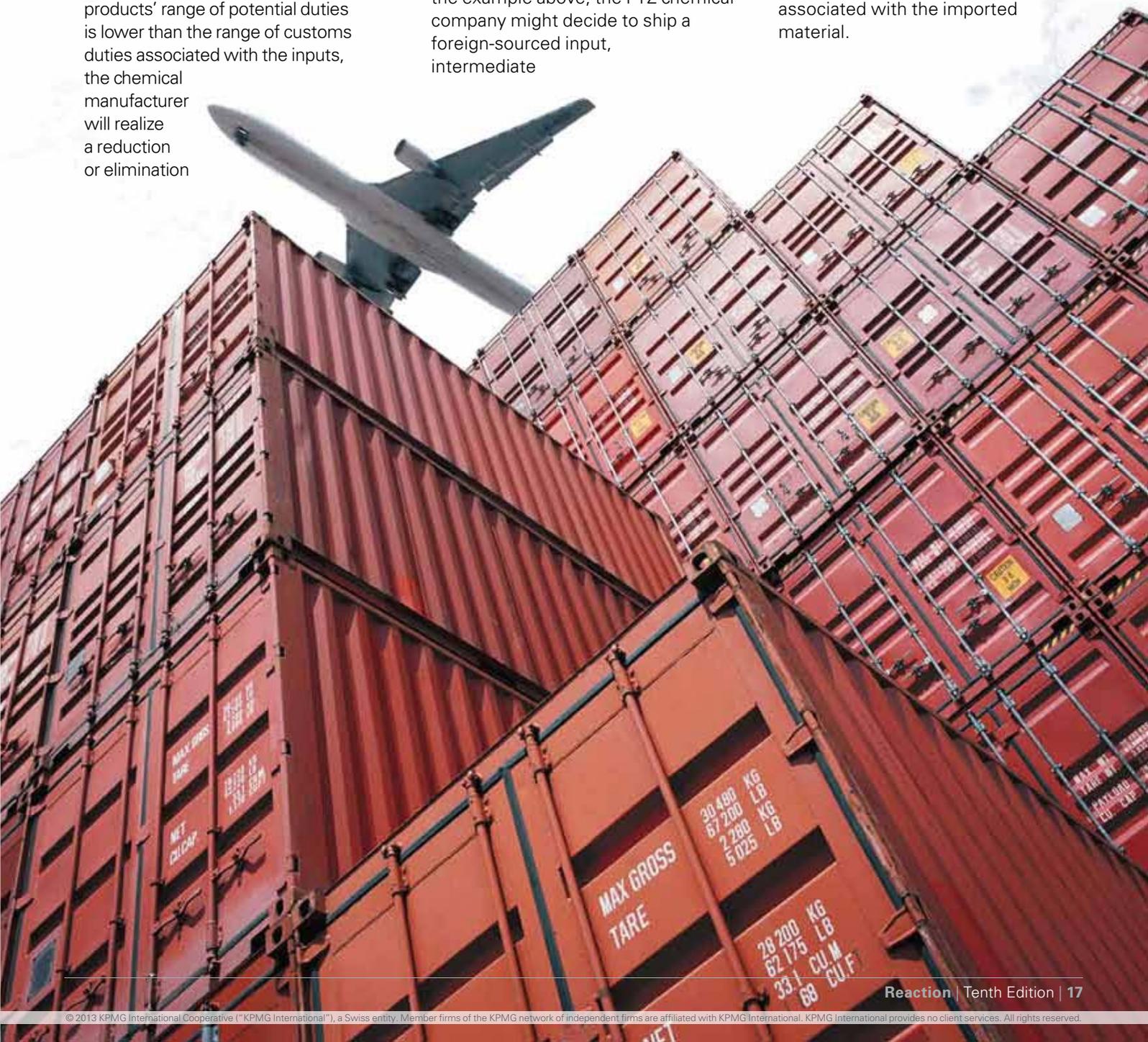
³ Free Trade Zones are known as Foreign Trade Zones in the United States.

and imported into US customs territory, the FTZ manufacturer may choose to pay tariffs on the foreign-sourced technical ingredients and raw material inputs that were received in the FTZ (0 percent to 7 percent) or the manufacturer can pay the tariffs (if any) on the silicon-based products shipped from the FTZ (0 percent to 6.5 percent). Given that the finished products' range of potential duties is lower than the range of customs duties associated with the inputs, the chemical manufacturer will realize a reduction or elimination

of customs duties. By eliminating the tariff barrier and encouraging production of chemicals in the US, the inverted tariff opportunity helps level the competitive playing field for US-based manufacturers vis-à-vis their foreign-based counterparts.

- **Duty Elimination on Exports, Scrap or Zone-to-Zone Transfers:** In the example above, the FTZ chemical company might decide to ship a foreign-sourced input, intermediate

product or a finished product that has a duty rate associated with it to another FTZ or for export. In that case, there is a full exemption from customs duties payable by the company. Likewise, if the FTZ chemical company destroys foreign-sourced materials within the FTZ, the FTZ chemical company may eliminate the customs duties associated with the imported material.



- **Duty Deferment:** Along with tariff-related benefits, FTZs can help chemical manufacturers and distributors improve their cash flow. Foreign-sourced inputs may stay in FTZ inventory indefinitely without the payment of customs duties and fees until the input, intermediate or finished chemical is shipped from the FTZ into customs territory. While dutiable materials are in inventory, the chemical company benefits from the deferment of customs duties. In addition to generating cash flow for the FTZ operator, duty deferment provides unique flexibility for multinational companies that wish to share inputs, intermediates or finished products with global counterparts. The FTZ enables the company to become part of a global, common inventory pool without

carrying the added expense of customs duties and fees typically associated with such an inventory.

- **Reduction in Customs Administrative Fees:** FTZs offer the possibility of substantial savings in administrative costs, especially in terms of merchandise processing fees payable to customs and customs broker charges. By enabling the FTZ operator to file just one customs entry per week covering all product withdrawn from the zone for entry into US Customs and Border Protection (CBP) territory, administration costs can be significantly reduced. The use of the weekly entry benefit is available to distributors and manufacturers and often translates into direct savings to the company.



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In 2012, the US Foreign-Trade Zones Board issued new regulations that have helped improve the FTZ program's flexibility, ease-of-use and transparency⁴. Designed to make the application process more efficient, the new FTZ regulations streamline the application procedures that manufacturers and distributors must follow to obtain the benefits of an FTZ. The new regulations are estimated by the board to reduce the application-related burden on users by more than 50 percent by enabling applicants to use a simpler application and by reducing the amount of time that the US Foreign-Trade Zones Board previously required for public comment periods and overall review timeframes.

⁴ *Fact Sheet: New Foreign-Trade Zones Regulations*, US Department of Commerce, accessed at <http://trade.gov/press/press-releases/2012/fact-sheet-new-foreign-trade-zones-regulations-021712.asp>

» Customs and tax coordination on related party pricing

To improve an organization's tax position, chemical companies have long used transfer pricing analysis to determine their intercompany prices for products that cross borders. This analysis is often conducted only from

a tax perspective, but there are very distinct differences in how CBP and the US Internal Revenue Service (IRS) typically view transfer pricing, as illustrated in the table below:

Differences	Customs	IRS
Objectives	Maximize COGS/import value	Minimize COGS/import value
Law	19 USC Section 1401a	IRC Section 482
Focus	Per unit price of imported goods	Aggregate income of importer
Time periods	Entry-by-entry declarations	Annual period
Comparable sets	Product/Industry comparability	Functional comparability
Tests	Circumstances of sale test/test values	IRC §1.482-3 methods
Measures if not arm's length	Rejection of transaction value/invoice price	Adjustment of transfer price/invoice price

Source: KPMG International, 2013

Companies that coordinate between their tax and customs compliance teams can develop a strategic transfer pricing policy designed to satisfy international guidelines, specific country customs regulations and business objectives.

In 2012, CBP finalized a long-awaited revision to its policy on transfer price adjustments⁵. The agency stated that, under certain circumstances, transfer price adjustments are compatible with the customs "transaction value" method, and the agency modified its policy to allow duty refunds for downward transfer price adjustments provided the following conditions are met⁶:

1. A written "Intercompany Transfer Pricing Determination Policy" is in

place prior to importation and the policy is prepared taking Internal Revenue Code section 482 into account;

2. The US taxpayer uses its transfer pricing policy in filing its income tax return, and any adjustments resulting from the transfer pricing policy are reported or used by the taxpayer in filing its income tax return;

3. The company's transfer pricing policy specifies how the transfer price and any adjustments are determined with respect to all products covered by the transfer pricing policy for which the value is to be adjusted;

4. The company maintains and provides accounting details from its books and

financial statements to support the claimed adjustments in the United States; and

5. No other conditions exist that may affect the acceptance of the transfer price by CBP (for example, the adjusted price must be arm's length from a CBP perspective).

For US chemical companies importing from related parties, this new ruling presents a further opportunity to adjust the reported customs values to the final transfer price of the imported goods after all applicable transfer pricing adjustments are made. The company can also potentially obtain a refund of duties paid in the case of downward adjustments.

⁵ *CBP Will Open the Door to Retroactive Transfer Pricing Adjustments and Potential Customs Duties Refunds, but Five Factors Hold the Key*, KPMG, June 11, 2012

⁶ Customs Bulletin and Decisions, Vol. 46, No. 23, page 14, dated May 30, 2012. See also page 11 where CBP states that the list of factors is conjunctive, meaning all five factors must be satisfied.

» Free Trade Agreements



Preferential or Free Trade Agreements (FTA) create free trade areas that can lower or eliminate tariffs and quotas on most goods and services traded among the participating countries. More than 100 regional and bilateral FTAs exist today, including the North American Free Trade Agreement (NAFTA), the Generalized System of Preferences (GSP), EU–Mexico, EU–Chile, US–Korea, EU–Korea, and others.

For global chemical companies, sourcing from countries with FTAs can result in potentially significant reductions in duties. Companies that further qualify their manufactured products under FTAs and can provide customers with the necessary certificates of origin can also

recognize the competitive advantage these agreements bring to export sales.

The challenge with FTAs is the varying rules with each agreement that, on their face, almost seem to intentionally exclude the chemical industry from being able to qualify their products under the standard origin rules. What many companies do not recognize are the special provisions often buried in the Annexes to the FTAs which provide opportunities to qualify chemicals for FTA preferential treatment depending on the chemical reactions which occur during production, among other requirements.

More than 100 regional and bilateral FTAs exist today, including the **North American Free Trade Agreement** (“NAFTA”), the Generalized System of Preferences (“GSP”), **EU–Mexico, EU–Chile, US–Korea, EU–Korea, etc.**

» Export compliance, emerging markets, and mergers and acquisitions

Exports are **generally controlled through two primary mechanisms:** national export control policies and embargo and sanction programs.

Many growth strategies developed by chemical companies include targeting sales to emerging markets and supporting growth through mergers and acquisitions (M&A). Both strategies are laden with potential export control implications that need to be carefully considered.

Exports are generally controlled through two primary mechanisms: national export control policies and embargo and sanction programs. We need to keep in mind that these controls are distinctly separate from controls for hazardous chemicals. National export controls generally control specific products for a variety of reasons, such as national security, chemical and biological warfare

and antiterrorism. The types of products controlled can sometimes seem relatively benign, such as triethanolamine (TEA), which is used in everything from cosmetics, to cement production to medications and is controlled for export purposes (under the export control classification 1C350)⁷. Therefore, it is important for chemical companies to evaluate their products and to ensure that appropriate processes are in place to prevent violations.

Embargo and sanction controls are a prevalent challenge when evaluating emerging markets in areas such as South America, the Middle East and Africa, among others. These trade barriers and markets are frequently changing and can

be a challenge to keep up with and to interpret.

The recently enacted Iran Threat Reduction and Syrian Human Rights Act of 2012⁸ for the first time imposes sanctions liability on a US company for any act by its foreign subsidiary that is in breach of the prohibitions against "US persons" (which has also been expanded to cover a financial institution, insurer, underwriter, guarantor, or any other business organization, including a parent and its foreign subsidiary or affiliate) dealing with Iran. The US parent companies must now disclose these activities, so they are working hard to identify those that are relevant under the law.

⁷ http://www.bis.doc.gov/complianceand enforcement/dontletthishappentoyou_2010.pdf

⁸ http://www.treasury.gov/resource-center/sanctions/Documents/hr_1905_pl_112_158.pdf



Ensuring compliance by a company's foreign affiliates with these US requirements has always presented a challenge, especially when the US requirements directly conflict with local country laws. This conflict presents an even more complicated situation for US chemical companies that often do not have visibility into foreign sales by affiliates or that sell through distributors or agents. Understanding the terms of the agreements with distributors and agents – including appropriate export control language – is becoming a critical step towards compliance.

Entering emerging markets also creates the necessity to stay abreast of foreign relations and other local trade-related movements. For example, many exporters have experienced the tightened import controls in Argentina.

Recently, the country adopted additional import licensing requirements in an effort to balance their trade deficit. These controls can delay or even prevent imports. In response, chemical companies have been exploring alternative shipment routes or ways to hold products in bond (e.g. where the shipment has not been cleared by customs and is transported or stored under the indemnity of a bond). However, these alternative approaches are complicated when the products to be imported are subject to numerous controls, such as being classified as hazardous or considered to be a drug precursor.

As such it is critical that trade and customs be considered as part of the M&A due diligence process, due to potential exposure from successor

liability (where the acquiring company is held liable for export violations committed by the target company). For companies involved in M&A, it is worthwhile to include a review of export controls of the target company. While it is possible to mitigate many of the customs risks involved, export control violations are fully inherited and are tagged with strict successor liability. In general, the chemical industry is highly controlled for export purposes, so reviewing target companies to assess past compliance is a crucial activity to include in the M&A process. Once a merger is complete, it is also recommended to review registration and licensing processes for chemicals with any new supplier, as well as with local customs and regulatory agencies in destination countries to avoid supply chain disruption.

» Conclusion

Today's chemical companies can improve their competitive position by understanding both risks and opportunities related to global trade and customs. The first step may be to assess current conditions and expected developments in your existing and

target markets with regard to import and export activity. You also need to determine that savings opportunities are addressed and compliance elements are integrated into the company's broader business and risk strategy.

A trade and customs policy can provide numerous benefits to organizations, especially in an environment marked by strong competition, lower margins and demand-side pressures. Chemical companies should evaluate their current trade-compliance programs

Risk strategies should also include trade and customs elements such as potential disputes with local and foreign governments about the **importation/exportation** of products. These disputes can be **very time-consuming and costly**.



to determine whether the use of FTZs and FTAs can mitigate their tax and duty liability while helping to streamline and potentially reduce their administrative burden.

Risk considerations should also include trade and customs elements such as potential disputes with local and foreign governments about the importation/exportation of products. These disputes can be very time-consuming and costly. It is therefore critical that chemical

companies understand their obligations, including how local legislation from countries such as the US could affect activities undertaken by subsidiaries and related entities in other jurisdictions.

Companies that successfully address these issues and include trade and customs elements in their business and risk strategies will be better positioned this year and in the future.



Chemical executives preparing for an uncertain global economy in

2013,

according to KPMG survey

As 2013 began, the US Congress and the Obama Administration enacted an agreement that addressed elements of the so-called “fiscal cliff” – specifically, as examples, revising income tax rates and delaying immediate Federal spending sequestration under the Budget Control Act of 2011. However, serious problems remain for the world’s economy. A recent KPMG survey of 100 global chemicals executives reveals major economic concerns as well as key strategies that companies are adopting for 2013.

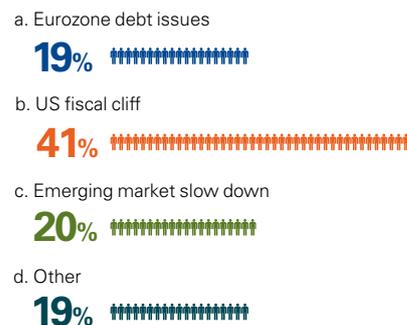
In October, when the KPMG survey was conducted, 41 percent of chemical industry business leaders indicated that their biggest business concern was the US fiscal cliff.

Industry reaction to the deal signed in January suggests that the mood of business leaders has not changed. “The compromise to avert the ‘fiscal cliff’ outlined by our leaders in Washington is a small step in the right direction,

but overall it’s a missed opportunity to revive our economy,” said Honeywell International Inc CEO David Cote.¹ Peter Huntsman, chief executive of chemical producer Huntsman Corp., was even more direct. “This deal’s a disaster. We’re borrowing more and more money. This did absolutely nothing to address the fundamental issue of the debt.”²

As you look at the macro-economic environment today, what is the biggest concern for you and your business?

Poll results



¹ CEOs complain that deal does not solve debt problem, Reuters, January 2, 2013

² Ibid.

Source: KPMG International, 2013

Nearly one-third (29 percent) of executives surveyed believed shale gas developments in the US will drive significant growth in petrochemical and downstream manufacturing, as the industry can increasingly take advantage of well-priced and reliable US-based feedstock. Additionally, 37 percent say US shale exports will force increased competition leading to price and margin erosion in Asia.

A significantly smaller group of respondents indicated that US shale gas would lead to a return of cyclicity to the US petrochemical industry (with sharp swings in supply and demand) or a negative impact to the petrochemical industry in Europe.

Where will be the primary focus of your emerging market growth strategy over the next three years?



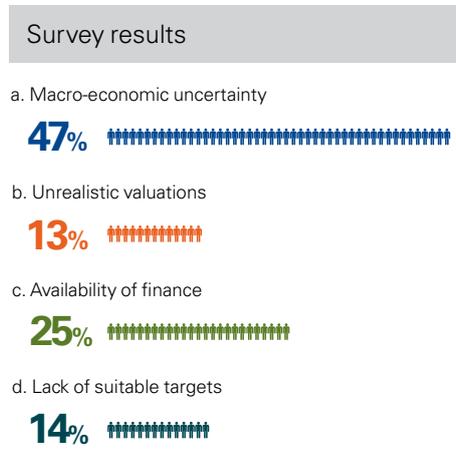
Source: KPMG International, 2013

When asked about emerging market strategies, China, not surprisingly, was the clear favorite (21 percent) when respondents were asked to identify a specific country. A slightly larger group (30 percent) reported that their company was taking a portfolio approach that includes markets in China, India, other countries in Southeast Asia, Brazil, and the Middle East.

A significant number of companies represented in the survey apparently have not developed or finalized any emerging market growth strategies. In fact, 28 percent of respondents said that their companies had no strategy in place.

"We found that response surprising," said Paul Harnick, chief operating officer of KPMG's Global Chemicals and Performance Technologies practice. "We see emerging markets as a critical growth factor for any large chemical company over the next decade, and demand in those regions will only continue to increase."

What do you see as the biggest constraints to M&A activity in the chemical industry today?



Source: KPMG International, 2013

A significant number of companies represented in the survey apparently have not developed or finalized any emerging market growth strategies.

While many executives in the industry are actively focusing on portfolio management, the level of M&A activity in the industry does not match the level of discussion. As in other areas discussed, macro-economic uncertainty was the key factor in discouraging M&A by chemical companies. Almost half (47 percent) of the respondents cited the economy as the main reason not to move on new deals.

The fact that 25 percent of respondents named availability of finance as another reason suggests that credit markets, although not completely frozen as they were in the first years of the global downturn, are still cool to the prospect of lending to companies.

The valuation gap between bid and ask prices may have closed, with only 13 percent of respondents citing unrealistic valuations as a limiting factor.

INDICES	
	CURRENT CHANGE
S&P/TSX COMP	↑ 9473.29 +102.32
S&P/TSX 60	↑ 528.81 +6.55
DOW JONES	↑ 10384.64 +127.69
NASDAQ	↑ 1962.23 +29.16
S&P	↑ 1175.65 +11.43

» Guarded optimism for the future

Global production outlook		
% change year-over-year		
Region	2012	2013
US	-0.5	1.8
Western Europe	-2.1	0.9
China	9.9	9.8
Total Asia-Pacific	5.0	6.8
Latin America	1.4	3.9
Emerging economies	4.9	6.8
Developed economies	-1.0	1.8
Total global outlook	1.2	3.6

Source: ACC, 2012



The economic news is not all discouraging. In December of 2012, the American Chemistry Council (ACC) reported that their Chemical Activity Barometer (CAB) had grown 2.8 percent from last year and had reached its highest level since August 2008.³ According to Kevin Swift, chief economist at ACC, the CAB reading suggests steady but slow growth for early 2013. A stronger gain of 2.3 percent is expected in 2014.⁴

However, the general consensus among analysts as well as with the executives surveyed by KPMG is that macro-economic uncertainty will most likely

continue to erode confidence and hinder growth in the global chemicals sector. Successful companies will focus on the fundamentals of operational excellence and financial strength, taking advantage of new access to US shale gas and emerging market growth in 2013 and beyond.

As Mike Shannon, global chairman of KPMG's Chemicals and Performance Technologies practice, explains, "Companies that are successful in these endeavors can gain a competitive advantage and be better positioned to capitalize if the economic tide turns."

³ Op. cit.

⁴ Ibid.

KPMG in the Industry



Chemical Industry CFO Roundtable

KPMG in the US will sponsor the upcoming Chemical Industry CFO Roundtable featuring economist Bernard Baumohl.

Bernard Baumohl is Chief Global Economist at The Economic Outlook Group, he also teaches at the New York Institute of Finance. Baumohl is well-known for being ahead of the curve in assessing the direction of the US and world economy. He is the author of *The Secrets of Economic Indicators: Hidden Clues to Future Economic Trends and Investment Opportunities*, and is a regular commentator on Public Television's *Nightly Business Report*.

During the roundtable, Baumohl will give his outlook for the US economy in 2013, and beyond, as well as his prognosis for the chemical industry.

In addition to Baumohl's interactive session, the roundtable will discuss current 'game changers' and core business issues as they relate to the chemical industry, including:

- Current signs of activity in, and threats to, chemical markets, and US position in them;
- The effect of shale gas on US competitiveness;
- The M&A environment;
- Valuing companies and financing acquisitions in an age of lower growth;
- The regulatory environment, post-US election;
- HR issues: Finding the right resources.





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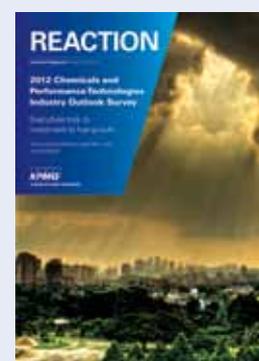
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