

Commentary

REACH due diligence – Extended scope of M&A services in the framework of REACH

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Market participants expect that transactions will continue to play a significant role in the chemical industry since the industry is still fragmented in many segments. Professional transactions in the chemical industry include Due Diligence processes with a focus on topics specific for the chemical industry.

The Financial Due Diligence focuses on the determination of future cash flows. Depending on the subsector of the chemical industry in which the target operates, the dynamics of the corresponding markets and consumers are highly different. Growth in sales and margin development of chemical products are different, depending on whether they are used e.g. in the textile-, the construction-, the automotive industry or in medical engineering. Furthermore, turnover and sales are depending on the targets', segment-specific cyclicality and its competitors activities, nowadays in particular competitors in China, India and the Middle East. In order to forecast the bottom line, it is important to understand in which cycles raw material and energy price fluctuations affect the target's financial ratios and whether the target is able to pass increasing costs on to its customers. It is necessary to evaluate if the target can be hedged against raw material fluctuations efficiently. Analysis of the fixed and variable characters of production-, marketing- and administration costs are in the foreground to determine the break-even point of the target. The costs for research and development (R&D) are analyzed with a focus on the determination of the R&D share allocated to specific close-to-market-applications.

The operational Due Diligence in the chemical industry focuses on the analysis of the num-

ber, arrangement ("Verbund"), flexibility and condition of the production facilities. An inspection is mandatory, especially to discover capex back-logs.

Considering the stipulation of REACH as the new EU chemicals regulation with dramatic impacts on many chemicals businesses, REACH Due Diligence has to be seen as a new Due Diligence discipline. During the M&A process it will be critical to know how the target is positioned and prepared for the REACH regulation. Although direct registration costs are known, concluding a transaction in the middle of a registration process could still be difficult when results of the registration application cannot be foreseen and/or restrictions can be expected. In addition to that sellers have to provide information about the current status of the registration process. A conflict might evolve, where the target will have an interest in presenting the registration process as less complicated and having less impact than in reality the case. Thus, in this period of the REACH process, the Due Diligence team is required to analyze the portfolio of substances produced or imported thoroughly and assess to what extend the portfolio is subject to REACH or not affected. In which phase/step of the process are the substances currently? Are they already pre-registered or even registered and which additional steps are still necessary in order to fulfill all registration requirements? Another question is what is the risk, if the target is not compliant with the REACH obligations within a specific timeline? Could it be expected that the production or manufacturing of substances will be prohibited? As a downstream user it should be considered, whether appropriate

steps have been taken to ensure that the substances that are purchased and worked with are subject to REACH and whether they will be adequately registered and authorized respectively. It is also fundamental to know, if appropriate risk management tools have been implemented coping with REACH. In the framework of a REACH Due Diligence it has to be reviewed, if the target is sustainably complying with the obligations out of the REACH regulation. REACH is definitely a quite sore process to go through and will impact M&A deals to a significant extent. Particularly buyers are in a precarious situation. In many cases they cannot receive detailed information from the sellers about the target since the sellers in many cases are unable to give a clear statement about the current situation. Otherwise, a big potential for buyers is implied in entities affected by REACH. In case they are already in a registration process for impacted substances, buyers will have to pay the registration fee anyway and can buy the targeted entity with a potential discount. In the future, REACH could be a support to the success of transactions, in particular those involving hazardous products – once the companies have fulfilled the obligations and once they are done with their registrations. REACH Due Diligence will therefore not only extend the Due Diligence perspective by „just another legal regulation“, but become a critical part of all data room documents and be a decisive core discipline of Due Diligence of chemicals and downstream user assets. This will not only be valid for strategic but also – and probably even more relevant – for financial buyers. In the middle of the ongoing credit crunch crisis, a more than ever thorough look on the target's risks will be mandatory to ensure the sustainable success of a transaction.