

REACH: Prudent Legislation or Regulatory Burden?

By Chris Cerimele

Recent legislation enacted by the European Union (EU) will likely have far reaching and costly implications on many segments of the global chemicals industry. Anyone who invests in chemicals or who manufactures, distributes or uses chemicals in the EU (or competes with EU chemical manufacturers) should be aware of the situation and its potential impact. The regulation is entitled **Registration, Evaluation and Authorisation of Chemicals**, or REACH, and it was adopted by the EU in mid-December. REACH is one of the largest, most complex and far reaching pieces of legislation enacted by the EU.

Passage of REACH followed a long process over several years designed to consolidate and improve upon the existing European patchwork legislative framework for chemicals. REACH replaces 40 pieces of legislation and creates a single regulatory system for all chemicals. It is based on the principle that chemicals used in the EU should not affect human health or the environment. The premise of the system is that industry must have certain knowledge of the properties of its substances and must use that knowledge to manage potential risks.

The immediate impact of REACH is clear: chemical firms who wish to do business in the EU must comply, and will likely incur significant cost to do so unless their products are subject to exemption. To put this in perspective, in 2005, the EU was the second largest world chemicals market, accounting for approximately 30% of non-pharmaceutical chemicals sales. The EU was the largest exporter and importer of chemicals, accounting for more than half of global trade.¹

How does REACH compare with the impact that Sarbanes-Oxley legislation (SOX) had for the regulation of public securities in the U.S.? There are some parallels. The biggest similarity is the scope of change in the regulatory regime and the breadth of changes in rules and requirements. REACH is one of the most

significant pieces of regulatory legislation to affect the chemicals industry in decades.

There is also the potential that, as with SOX, the cost of compliance will be high, will fall disproportionately greater on smaller firms, and may induce some smaller firms to withdraw products from the EU market. This would be similar to the situation in the U.S. where, for example, the cost of SOX compliance led some smaller public companies to take themselves private. The European Commission (EC) assumes that some products will be withdrawn as a result of REACH implementation. However, REACH differs from SOX in that it contains a "One substance, one registration" principal whereby there is joint submission of information for a particular substance by multiple registrants. This could potentially ease the registration cost for smaller companies.

The bigger question, which remains to be answered, is how REACH will impact the balance of global trade. Many Europeans have expressed concern about the cost impact of REACH compliance on the competitiveness of EU chemical manufacturers, who are already under pressure from other parts of the world. "Our ability to compete internationally will be under greater pressure because of REACH," noted Werner Wenning, president of German chemical trade group VCI.² Some have estimated that the cost of registering a single substance in some cases could exceed €1 million. On the other hand, REACH applies to all firms who supply or use chemicals in the EU, regardless of their primary geographic location. As such, it could potentially serve as a barrier to entry into the EU marketplace.

Aside from cost, one of the more onerous and unpopular provisions of the system concerns the substitution requirement for dangerous substances. Under this requirement, firms must determine whether there are safer suitable

alternatives and if there are, must prepare substitution plans. The substitution requirement was added as a last minute compromise to ensure passage of the law, and is viewed by some in the industry as unnecessary and overly burdensome. Jack Gerard, President of the American Chemistry Council, has called the substitution requirement "a poor use of time, energy and resources" that "will lead to unintended and potentially adverse consequences".²

What will REACH mean for chemicals M&A? Time will tell, but it will likely be company specific since the regulations will affect companies differently depending on their role in the supply chain and the substances they produce. REACH is a cost of doing business, so the amount of added cost and a company's ability to pass along that cost will impact profitability, and thus market value. Although, as noted above, the REACH regulations could present an additional barrier to entry into the EU, the provisions are probably not onerous enough to spur a significant amount of defensive acquisition activity. We believe the most likely scenario is that REACH will present additional opportunities to realize cost synergies in connection with acquisitions but will not necessarily generate significant additional M&A volume per se.

The following overview of REACH is based on information provided by the European Commission:³

How it Works. The basic elements of REACH involve data gathering and information sharing. Information on the properties of substances will be gathered by manufacturers and importers, and registered into a central database that will be used as a repository of knowledge to help manage the health risks of substances. The REACH regulations and database will be administered by a new European Chemicals Agency. There are data sharing rules included to help prevent duplicate work by multiple

(Continued on page 2)

registrants and to reduce animal testing. In addition, there is a substitution requirement whereby safer alternatives must be sought for certain dangerous substances.

Another element of the system is that downstream users (DUs) are also responsible, not just manufacturers and importers. DUs include industrial users of chemicals, whether formulators of preparations (e.g., paint producers), users of chemicals such as oils and lubricants in other industrial processes, or producers of manufactured articles such as electronic components. Under REACH, DUs must consider the safety of their uses of substances, based primarily on information from their suppliers.

Substances Covered. All substances, whether manufactured or imported, in volumes over 1 metric tonnes annually, are covered unless specifically exempted. This includes substances contained in manufactured goods such as cars, textiles, electronic chips, etc. The EC estimates that over 30,000 substances, excluding intermediates, will be registered over the first 11 years under the system. Unlike previous regulatory initiatives, there is no exemption for substances that are

already on the market. In fact, data gathering on existing substances is a major objective of REACH.

Specifically excluded from registration requirements are food, waste, polymers and certain substances that are already regulated under other legislation, such as medicinal products, or that generally present low risks such as water, oxygen, certain noble gases and cellulose pulp. Also excluded are certain substances occurring in nature such as minerals and ores, as long as they are not chemically modified.

Timing of Implementation. REACH takes effect on June 1, 2007 and the requirements are set to phase in over time. Many of the provisions begin to apply and fees become due beginning June 1, 2008. The first registration period for the most dangerous and/or higher volume substances expires on December 1, 2010.

Cost of Compliance. The EC estimates the costs of REACH to be in the range of €2.8 - €5.2 billion over a period of 11 to 15 years. This includes both the direct cost to the chemicals industry and the indirect cost to downstream users. The cost estimate assumes that 1%-2% of

substances will be withdrawn because their continued production would not be profitable. To reduce costs, industry participants are encouraged to cooperate and to jointly submit registration information.

Benefits. As noted above, REACH replaces a patchwork of regulations and creates a single regulatory regime for all chemicals in the EU. By closing the knowledge gap for more than 30,000 existing substances, it provides information on both their acute and long-term effects. It encourages the use of safer substances and reduces animal testing by requiring data sharing. The EC calculates benefits by assuming positive occupational and public health effects (i.e., reduced healthcare spending and fewer deaths) due to reduced exposure to hazardous chemicals. On that basis, the EC estimates the benefit to be approximately €50 billion over a 30 year period.

1. Source: European Chemical Industry Council (CEFIC) (<http://www.cefic.org/factsandfigures/>).
2. As reported by ICIS Chemical Business Americas.
3. See http://ec.europa.eu/environment/chemicals/reach.reach_intro.htm.

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