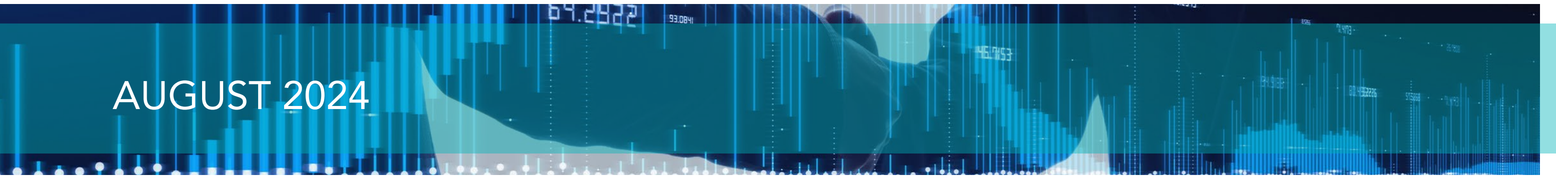
MANUFACTURING M&A MINUTE

HUNTON ANDREWS KURTH



AUGUST 2024

Market Snapshot

Multiples (based on EBITDA) for manufacturing business with an enterprise value between $10M and $250M have dropped from a peak of **7.3x** in 2022 to **6.8x** YTD in 2024 but are up from **6.5x** in 2023.

Deal uncertainty and failed processes remain frustratingly high – Datasite identified only **49%** of processes that used its infrastructure as closing in 2023 (down **9%** from 2022).

Multiples remain higher in deals above $50M and above – deals with a value of $100 to $250M have seen multiples with an average of **7.5x** in 2024 with deals between $10M and $50M trading at average between **5.5x** and **5.8x**.

Rising interest rates may be playing a role in a slight uptick in equity as a portion of a buyer's funding for new platforms as the average percentage of consideration comprised of equity funding in 2024 is **58.8%**, compared with **52.2%** in the low-interest rate environment of 2021.

Similarly, platform acquisitions in the manufacturing space have seen total debt/EBITDA ratios decrease from a high of **4.4x** in 2022 to **3.5x** YTD in 2024.

Borrowers will still miss the heady days of 2021 and 2022 when senior debt was rarely priced in the double digits but recent movement has been in a negative (or positive, depending on your perspective) direction with senior debt pricing for deals between $10 and $250 million falling to **9.3%** in Q2 as compared to **11.0%** in Q4 of 2023. environment of 2021.

Quick Numbers

0.01% decrease in private equity "dry powder" at end of Q1 2024 vs Q4 2023, the first such decrease in over 10 years (Preqin)

42.1% increase YoY in Q2 global private equity and venture capital deal volume (S&P Global Market Intelligence)

2006 is the last year deal volume for inbound investment into the US from Chinese businesses was as low as the first half of 2024 (Nikkei Asia)

2008 was the last Olympics until the 2024 Olympic Games that China won 40 or more gold medals

Quick Links

FTC Final Rule Limiting Non-Competes: Considerations for M&A Transactions

BACKGROUND

On April 3, 2024, the Federal Trade Commission ("FTC") published a final rule (the "Final Rule") that would significantly curtail the use of employee non-competes throughout the United States and invalidate many existing agreements subject to a few exceptions.[1] The Final Rule was set to become effective on September 3, 2024. U.S. District Judge Ada Brown of the Northern District of Texas struck down the [Final Rule](#) in a decision on August 20, 2024 that will almost certainly delay the implementation of the Final Rule and puts any future implementation in peril. That said, the judgement will be appealed and the legal saga relating to the Final Rule is far from over.

Below we discuss some of the implications on employee retention in the M&A context if the Final Rule were to be implemented as written. Even if the Final Rule were to be substantially modified or invalidated altogether, the strategies and concepts laid out here will remain relevant and still be useful alternatives when considering state law restrictions or deal dynamics that make non-competes less palatable.

The Final Rule allows a sale-based non-compete to be valid for any individual entering into such non-compete clause pursuant to a "bona fide" sale, including such individual selling their ownership interest in the business entity, seemingly regardless of the size of their interest.

From an employment agreement perspective, the Final Rule invalidates all new non-competes and restricts enforcement of existing non-competes subject to a few exceptions. Our colleagues discuss the employment aspects of the Final Rule in more detail [here].

Historically, non-compete agreements executed by sellers in connection with the sale of a business have garnered less scrutiny from agencies and courts than non-competes in the context of post-employment restrictions and the Final Rule maintains this lineage by preserving the ability to obtain non-competes from sellers of a "bona fide" interest in a business entity is a welcome. Below, we discuss further how the interpretation of "bona fide" may impact the application of a Final Rule, but at the highest level, business principals and in-house counsel should be aware that the sale of business exception is preserved in the Final Rule and can apply to any seller in a sale of a business entity (regardless of the size of the ownership interest sold or the purchase price paid for such interest) so long as the exception is utilized in connection with a "bona fide" sale.

Another point in the Final Rule that will be notable for transactional professionals is the inability of firms to enforce employment-based non-competes that were in existence prior to the implementation of the Final Rule if such non-competes would be prohibited under the Final Rule. This means that almost all non-competes entered into in a context other than the sale of a business will no longer be enforceable, with the sole limited exception in the employment context applying to existing non-competes with "senior executives."[2]

[1] Non-Compete Clause Rulemaking, FTC Federal Register Notices (Jan. 5, 2023), www.ftc.gov

[2] A "senior executive" for purposes of the Final Rule is generally defined as an employee who received total compensation of at least $151,164 in the preceding year (with the ability to annualize for employees who worked less than a complete year) and are in a "policy-making position." See Final Rule at 563.

M&A TRANSACTIONS AND IMPLICATIONS OF THE FINAL RULE

M&A transactions where the continued employment of key individuals at the target is a component of the purchaser's value thesis will be the most impacted by the Final Rule. While traditional seller non-competes entered into in connection with a bona fide sale will remain unaffected by the Final Rule, M&A professionals will need to be creative in retaining employees who are not sellers in a sale of a business transaction and with respect to restrictive covenants for employees who "rollover" some portion of their existing equity in transactions or receive equity awards. Below, we highlight certain key issues that we expect M&A professionals to grapple with if the Final Rule is implemented and addressed by dealmakers in the marketplace:

EMPLOYMENT AGREEMENTS:

While non-compete clauses in employment agreements will no longer be permissible for individuals upon implementation of the Final Rule (other than those applicable to "senior executives" prior to the effective date of the Final Rule), employment agreements remain powerful and straightforward tools to align incentives between key employees and buyers after the closing of a transaction. To incentivize performance and promote retention of key employees, employment agreements may provide for increased deferred compensation, the issuance of equity or payment of bonuses based on certain performance metrics of the business. Our expectation is that the Final Rule will lead to a slight shift in employment agreements that previously may have emphasized the "stick" of a non-compete to retain employees to agreements that instead rely on "carrots" designed to incentivize the employee's retention through compensation and other enticements. As has always been the case, employers will also need to consider state law with respect to the enforceability of existing non-competes and other related restrictive covenants even if the non-compete in question would be permitted under the Final Rule.

GRANTS OF ROLLOVER EQUITY:

The issuance of rollover equity to selling equityholders is not a new tool but the prevalence of, and importance of structuring, rollover equity arrangements may increase as a means of creating incentive for key employees to remain with a company following a change of control transaction.

Many sponsors include a non-compete in the stockholders agreement, limited liability company agreement or other governing document tied to the ownership of rollover equity or equity grants. These non-compete provisions typically apply for some period of time after the subject equity is no longer held by the individual in question. While sale of business non-competes are explicitly permitted under the Final Rule, we suspect that the use of "springing" non-competes applicable to minority equityholders who may be "dragged" or forced to sell their equity as part of a larger transaction may draw additional scrutiny due to the "bona fide" sale requirement.

While the Final Rule does not explicitly discuss "drag-along" rights, the Final Rule includes a discussion which expresses skepticism towards "springing" non-competes which the Final Rule describes as a non-compete provision in which a worker "must agree at the time of hiring to a non-compete in the event of some future sale" and "repurchase rights, mandatory stock redemption programs, or similar stock-transfer schemes" (pursuant to which a worker may be required to sell their shares if a certain event occurs).[3] Given the FTC's general focus on preventing non-competes and the Final Rule's lack of a bright line safe harbor for these types of restrictions, dealmakers should not

[3] Final Rule at 342.
[4] Final Rule at 342.

trust non-competes in equity documents to serve as a silver bullet in preventing equity-holding employees (or other individuals from competing after the sale of equity).

To the contrary, the Final Rule makes clear that "springing" non-competes and non-competes arising out of repurchase rights or mandatory stock redemption programs are not entered into pursuant to a bona fide sale because "in each case, the worker has no good will that they are exchanging for the non-compete or knowledge of or ability to negotiate the terms or conditions of the sale at the time of contracting."[4] The FTC declined to further delineate which kinds of sales transactions would not constitute a "bona fide" sale under the exception, but noted that courts have identified and prohibited such schemes in the past.[5] In particular, the FTC cited a California Court of Appeals case in which the court refused to enforce a non-compete imposed on a physician under an agreement which required the physician to purchase nine percent (9%) of the stock at hiring and resell the stock to the corporation upon termination because the agreement "was devised to permit plaintiffs to accomplish that which the law otherwise prohibited: an agreement to prevent defendant from leaving plaintiff medical group and opening a competitive practice."[6]

Nothing in the Final Rule or the ambiguity around application of the bona fide sale test should discourage sponsors from using equity as a tool to incentivize retention and reward growth but any reliance on post-sale non-competes that arise due to a drag-along right or other forced sale provision should be tempered by the Final Rule's fairly strong negative presumption against these provisions.

Sponsors and other investors may also increase their focus on enforcing and clarifying traditional corporate law doctrines which touch on similar concepts addressed by employment-based non-compete clauses. In particular, sponsors may choose to emphasize the application of traditional fiduciary duties such as the duty of loyalty and the related corporate opportunities doctrine to management directors and officers. While these doctrines typically apply to directors and officers of a company, in certain instances, they may also apply to equityholders and therefore may extend beyond the individual's employment with the company.

LOOKING FORWARD

The Final Rule has been subject to numerous legal challenges which have called into question whether or not the Final Rule will ever be implemented. Despite the potential for delay of implementation or complete invalidation, M&A practitioners should be familiar with nuances of the Final Rule and alternative tools to incentivize employee retention. Regardless of eventual implementation of the Final Rule, the publicity around the rule and state law issues have made an understanding of multiple methods of employee retention a crucial point for dealmakers.

The Hunton Andrews Kurth team will be closely following updates and developments around the Final Rule, and will remain available to discuss questions or concerns about companies' approaches to non-competes and alternatives to non-competes in connection with M&A transactions.

Ryan Glasgow
Partner, Richmond

[4] Final Rule at 342.
[5] Final Rule at 343.
[6] Final Rule at 343 (citing *Bosley Med. Grp. V. Abramson*, 161 Cal. App. 3d 284, 291 (Cal. Ct. App. 1984)).

Q&A With Mason Zuniga

Vice President, Corporate Development
MW Components

Q. Can you explain to us your role with MW?

A. I've been at MW for about three and a half years and currently serve as the Vice President of Corporate Development. We are a manufacturer of springs, fasteners, and other precision components. My primary focus is executing our M&A growth strategy, which includes target identification and cultivation through due diligence and integration. In addition to M&A, I help with special projects, such as consolidations, and manage our real estate assets (i.e., lease renewals, sale leaseback transactions, etc.).

Q. When evaluating acquisition targets, beyond strong financial metrics, what makes a business stand out as a particularly attractive acquisition opportunity?

A. The answer to this question can vary deal-to-deal depending on strategic fit. Strong financial metrics are table stakes in our view, however they are not the end-all be-all. Each of MW's divisions has a prioritization matrix that helps guide our M&A strategy, with growth as the common underlying theme. It sounds simple, but our goal is to acquire great, synergistic businesses with really strong leadership teams that make us more competitive in our current markets or help us gain access to new target markets. "Synergistic" can mean a lot of different things, but at the end of the day it's all about driving growth and creating value for MW, our customers, and our employees. We think approaching transactions with a clear strategy and well-defined screening criteria enables us to move very quickly when we find a great business and a great team. It's something we certainly take pride in.

Q. Has the interest rate environment over the past 24 months changed how you evaluate opportunities?

A. Yes and no. M&A has been one of our key growth drivers since the mid-1990s, and we've continued that trend through a number of economic cycles and interest rate environments. With that said, I wouldn't say that rates have "changed" the way we evaluate opportunities, but we've adapted and added additional scrutiny around some of our key due diligence items and screening criteria as the cost of borrowing rises. While global M&A and the general manufacturing market have slowed since 2021/2022, we've remained very busy on the acquisition and capital deployment front. We closed three transactions in the last 24 months and invested a significant amount of capital into new equipment, facilities, and projects that we believe position us as a leader in our markets. That exemplifies the resiliency of our business and the commitment we have to our customers of remaining ahead of the curve to better service them.

Q. MW is a company with primarily US operations that has made a number of acquisitions in the Midwest over the past few years. Given a trend towards "on-shoring" of manufacturing operations out of COVID-driven supply chain issues, this strategy has been validated but can you explain a bit more about how your acquisition strategy ties to creating certainty in the supply chain both for MW and its customers?

A. A large portion of providing "certainty" to our customer base stems from our commercial and operational fundamentals (e.g., customer service, delivery, quality, etc.). However, from an inorganic perspective, we are always looking at adding new products and processes while creating scale, which helps advance our efforts to create a differentiated value proposition. A great example is our Fasteners division – we're currently executing a multi-site consolidation in the Chicagoland area that will include a 189,000 square foot, state-of-the-art manufacturing facility and a dedicated distribution center. We will be able to handle R&D, product launch, growth and maturity, and end of life production all in the same facility. Additionally, we committed resources and capital to handling ultra-high volume imports for customers that want that service in addition to our domestically manufactured parts. This scale was created through a series of acquisitions all centered around our goal of being the leading specialty fastener manufacturer in the market. This type of strategic vision coupled with our relentless commitment to serving our customer is what ultimately creates that certainty you referenced.

CTA Considerations for Transactional Professionals

You may or may not have heard about the implementation of the Corporate Transparency Act (the "CTA") that went into effect this calendar year. For background, Congress passed the CTA in 2021 to combat money laundering by requiring certain entities to report Beneficial Ownership Information ("BOI") to Financial Crimes Enforcement Network ("FinCEN"). FinCEN issued final regulations outlining the BOI reporting procedures and requirements, which went into effect on January 1, 2024.[1] While the CTA provides reporting exemptions for numerous types of entities, most corporate structures will have to provide some level of reporting on their entities to FinCEN as part of the CTA.

You may be wondering why dealmakers should care about something that may sound more like the domain of compliance teams and regulatory lawyers. Let us explain . . .

IMPACTS ON DUE DILIGENCE

As with any regulatory regime, buyers do not want to step into a filing headache or, worse yet, liability for non-compliance with the CTA prior to the closing of a transaction. For this reason, savvy buyers have already updated their due diligence checklists to include requests about a target's CTA filing and compliance.

Identifying any issues with a target's CTA filing process (or lack thereof) is better done early in the diligence process so that corrective actions, if necessary, can be taken prior to closing. These corrective actions will have the dual effect of giving a buyer comfort that they are not stepping into a potential regulatory liability while also giving sellers comfort that they will not be subject to an indemnity claim for failure to comply with the CTA.

Acquirers are keen to see all of a target's prior CTA fillings, amendments and communications between the seller and FinCEN relating to CTA compliance. A diligent buyer wants to ensure that not only have all required CTA filings been made, but the filings are accurate, complete and any exemptions claimed were properly identified. Many sellers, particularly closely held companies, have no problem sharing their CTA filings since the information submitted to FinCEN closely matches cap tables and other ownership information provided in the ordinary course of diligence. However, targets with a more complex ownership structure, including private equity portfolio companies, may be reluctant to share their CTA filings if they disclose beneficial owners who otherwise would not be identified in a diligence process. In most cases, this unwillingness to share this information is not driven by any nefarious reason but to protect the identity of beneficial owners for both privacy and competitive reasons. While the CTA is still in its relative infancy, the most common solution for this concern that our practitioners have seen is establishment of a "clean team" arrangement or inclusion of CTA filings in an existing "clean team" folder of a data room. The "clean team" members who typically would review such filings are external counsel who are likely to be the subject matter experts on CTA with most business teams having little concern about the substance of CTA filings so long as they are compliant with all requirements.

Buyers will also be interested in confirming the appropriate application of any of the numerous exemptions to the CTA that may be utilized by targets. Beyond the obvious diligence action of confirming the exemption is properly applied, buyers are often interested if the subject transaction will remove the exemption or potentially introduce new exemptions that need to be identified to FinCEN.

As always, savvy selling parties can expedite the diligence process by getting ahead of CTA issues before opening data rooms and sharing CTA information with potential buyers by going through a similar "sell-side diligence" exercise that provides background and explanation for any non-standard CTA filings.

[1] For a broad overview of the CTA, see previous Hunton client alert.

WHAT ARE BUYER'S PROTECTING AGAINST?

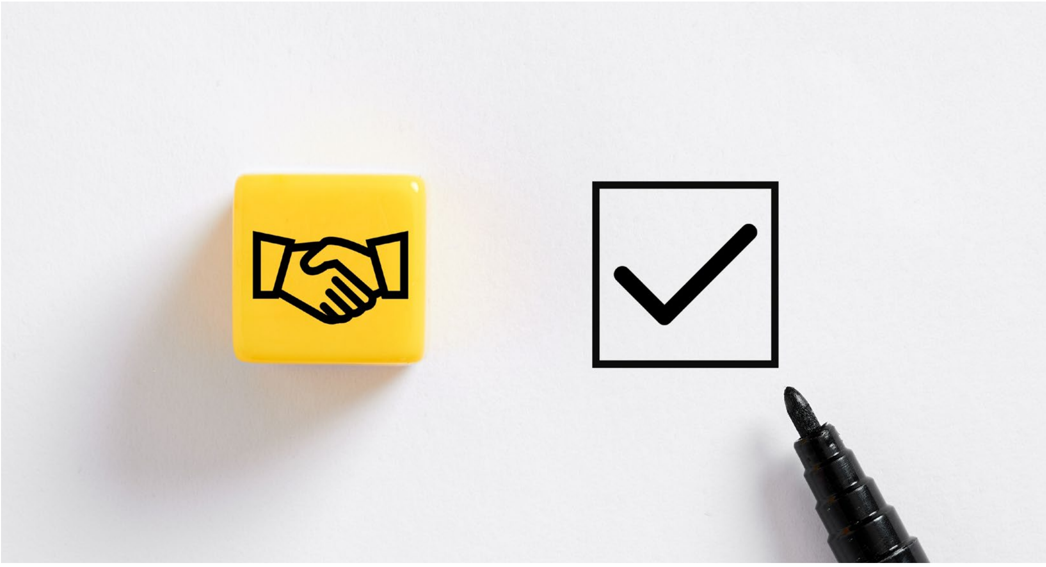
Violations of the CTA reporting obligations can result in monetary penalties of up to $500 per day of an ongoing violation (up to $10,000 maximum per entity) and criminal penalties of up to two years imprisonment. While CTA enforcement actions have not begun in earnest as of the date of this publication, the monetary fines can add up in structures with a significant number of legal entities. We expect that criminal penalties will be reserved for bad-faith actors, but the mere threat is enough to get the attention of C-suite members responsible for acquisition activities.

Buyers are increasingly adding representations around CTA compliance, and accuracy of filings and exemptions claimed, to purchase agreements. Typically, if a buyer is comfortable with their diligence around a target's CTA compliance, a standard representation, subject to whatever indemnity rights may exist under the acquisition agreement, is sufficient comfort. However, if buyer's become aware of issues with past CTA filings, specific indemnities, covenants to correct filings and other drafting tools can be utilized to more appropriately allocate risk.

POST DEAL CONSIDERATIONS

We've been pleased to see closing dinners make a post-COVID return to the M&A world (our waistlines haven't). Our buy-side clients have been slightly less pleased to have another item added to their post-closing checklists by the CTA. In many cases, buyers will need to update CTA filings for targets to reflect new ownership within 90 days of an acquisition, including addressing any prior exemptions claimed and/or applying exemptions that may be applicable to the acquiring group.

Given the numerous exemptions and somewhat complex nature of determining beneficial ownership for CTA purposes, we recommend that sellers and buyers engage counsel early in the deal processes to ensure that CTA issues do not catch anyone by surprise closer to closing. Hunton has a comprehensive team of lawyers working across practice groups to advise on all CTA issues that may arise in M&A matters (and we promise not to talk about the CTA at the closing dinner).



PFAS: It's Everywhere… Including M&A

We are now within the 1-year window of the deadline companies are facing to submit their reports to EPA regarding their importation or manufacturing of per -and polyfluoroalkyl substances (PFAS) under the Toxic Substances Control Act (TSCA). The Chemicals team at Hunton has prepared a helpful list of frequently asked questions and we have provided a bit more background on the reporting obligations at the end of this article. Given the sensitivity and nuance of the issue, companies with existing operations that use PFAS or considering acquisitions or dispositions involving operations that use PFAS should consult with counsel and environmental experts to understand the implications.

Although the PFAS Reporting Rule itself does not explicitly address changes in company ownership, dealing with an ownership change will cause reporting questions beyond just traditional M&A activity because the PFAS Reporting Rule has a 12-year lookback period.

EPA's Fact Sheet: Reporting After Changes to Company Ownership or Legal Identity provides guidance on reporting obligations after there are changes to company ownership or legal identity.

While this guidance is for another TSCA regulation, the Chemical Data Reporting rule, these principles also apply to the PFAS Reporting Rule. Companies that have experienced changes in ownership since January 1, 2011 may find their scenarios listed in EPA's Fact Sheet.

The guidance presents many examples of changes in company ownership and describes which entity is required to report information on chemicals produced or imported. One example involves the carve-out of a business unit, which is paraphrased below:

> Company X sells Division A to Company Y and both Company X and Company Y continue to exist with Division A transferred through a typical carve-out asset acquisition.
>
> In this instance, Company Y would be required to submit data reports based on manufacturing/importing activities by Division A subject to a reporting obligation conducted during the years of the applicable reporting period, **including the manufacturing that Division A did before it was acquired by Company Y**.
>
> Company X submits data reports based on any manufacturing activities subject to a reporting obligation conducted during the years of the applicable reporting period, **excluding the manufacturing that Division A did during those same calendar years**.

While the above provides just one example, the takeaway for companies engaging in M&A activity is that they should be aware of the new TSCA reporting requirements and consider how they may apply to their acquisitions. Notably, the TSCA reporting requirements do not require a company to take on additional investigative work in order to determine if they may have engaged in "reportable" activity in the past. This does not mean that acquirers should turn a "blind eye" to past behavior of targets but rather tailor diligence requests and environmental review to appropriately identify if reporting is required and to produce any documents that would be useful in supporting any required reporting.

UPCOMING REPORTING DEADLINE

The reporting rule requires entities that have manufactured or imported PFAS, or imported PFAS-containing products, for commercial purposes at any time between January 1, 2011 and December 31, 2022, to submit detailed reports within the applicable submission period. For many companies, the submission period begins on November 13, 2024 (which is one year after the rule's effective date) and lasts six months, through May 8, 2025.

Small importers whose reporting obligations are exclusively due to article importation have until November 10, 2025 to report. An importer is "small" under TSCA if it meets one of two standards: (1) an importer whose total annual sales, when combined with those of its parent company, are less than $120 million, and the annual import volume of a chemical substance is less than 100,000 pounds; or (2) an importer whose total annual sales, when combined with those of its parent company, are less than $12 million.

It is crucial for companies to understand the expansive scope of this rule, which differs significantly from most TSCA reporting regulations and impacts many companies that may be unfamiliar with TSCA. Even the importation of one product or product component containing trace amounts of PFAS could trigger reporting obligations. Therefore, although reporting begins in November, it may take companies months to do their due diligence to ascertain what information is "known to or reasonably ascertainable by" the company and gather information required for reporting. This is particularly true for companies with complex supply chains and who manufacture or import many types of products.

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