Alternative Methods for Valuing Customer Relationships
• Mr. Patel is a Managing Director with VRC and specializes in the valuation of businesses, assets and liabilities for financial reporting purposes.

• Mr. Patel is an active member of the Appraisal Industry Task Force (AITF).

• He is a member of the Appraisal Foundations Working Group preparing an industry Practice Aid for valuing customer related assets.

• Mr. Patel is a frequent presenter on valuation issues for financial reporting purposes and has recently presented on valuation issues relating to ASC 805 (SFAS141R), ASC 350/360 (SFAS142/144), ASC 820 (SFAS157) and other emerging issues. In addition, Mr. Patel was on the Fair Value Panel at the 2008 AICPA SEC Conference. He has been quoted numerous times in the press regarding valuation issues.

Contact Information:
ppatel@valuationresearch.com
Direct: 609.243.7030
Mobile: 609.240.1337
Ray Rath, ASA, CFA

- Mr. Rath is a Managing Director with Globalview Advisors, LLC. He specializes in valuing businesses, assets and liabilities for financial reporting purposes.

- Mr. Rath is a member of the AICPA Investment Companies Task Force for AICPA Accounting and Valuation Guide, *Determining Fair Value of Portfolio Company Investments of Venture Capital and Private Equity Firms and other Investment Companies*.

- On behalf of the ASA, Mr. Rath led the development of two three day courses on the valuation of intangible assets.

- Mr. Rath is a frequent presenter on valuation issues for financial reporting purposes and has recently presented on valuation issues relating to ASC 805, ASC 350/360, ASC 820 and other emerging issues.

Contact Information:
rath@globalviewadvisors.com
Direct: 949.475.2808
Mobile: 323.229.9447
Topics Covered in the Valuation Advisory

• Accounting background and overview
• Identification of customer-related assets and valuation considerations
• Valuation methodologies
• Valuation methodology selection
• Other considerations
• Appendix on attrition rate calculations
• Appendix of case studies
Continuum of Customer Assets

- Customer lists
- Transactional purchase order based customers
- Transactional customer relationships with MSAs
- Recurring customer relationships with switching costs
- Customers with long term contracts
- Take or pay contracts
Identification of Customer-related Assets and Valuation Considerations

- Qualitative understanding of the relative importance of the customer-related asset being valued:
  - Industry characteristics
  - Company characteristics
  - Product/service characteristics
  - Customer-related asset characteristics

- Other key factors to consider:
  - Barriers to change
    - Stickiness of customer relationships
    - Switching costs

- Qualitative attributes are just as important as quantitative attributes in determining the value of customer relationships
Valuation Approaches

• Income Approach
  • Multi-Period Excess Earnings Method
  • Distributor Method
  • With-and-Without Method
  • Cost Savings Method

• Cost Approach
• Market Approach
Summary of Methods: MPEEM

**MPEEM based customer cash flow**

Company revenue/earnings
Less: Taxes
Less: Charges for contributory assets
Equals: Cash flows related to customer relationships

- Residual cash flow model
- Best used when:
  - Customers are the primary assets or
  - Margins are within a reasonable range of normal industry levels
Sample MPEEM Cash Flow Calculation

Revenue Adjusted for Growth $100,000
Remaining After Attrition 95.0%
Revenue After Attrition 95,000
EBITA 19,000

20.0%

Less: Royalty for use of Trademark (9,500) 10.0%
Adjusted EBITA 9,500

Less: Income Taxes 3,800
Debt Free Net Income 5,700
Debt Free Net Income Margin 6.0%

Contributory Asset Charges
Normal Working Capital (1,425)
Property, Plant & Equipment (1,900)
Workforce (1,045)
Return on Supporting Assets (4,370)

-4.6%

Residual Income 1,330
Summary of Methods: Distributor Method

Distributor Method based customer cash flow
Company revenue
Earnings of market proxy
Less: Taxes
Less: Charges for contributory assets (based on market proxy)
Equals: Cash flows related to customer relationships

- Residual cash flow model but isolates cash flows relating to customer relationships

- Best used when:
  - Customers are NOT the primary assets or
  - A reasonable market proxy exists for the customer relationships
### Sample Distributor Method Cash Flow Calculation

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue Adjusted for Growth</td>
<td>$100,000</td>
</tr>
<tr>
<td>Remaining After Attrition</td>
<td>95.0%</td>
</tr>
<tr>
<td>Revenue After Attrition</td>
<td>95,000</td>
</tr>
<tr>
<td>EBITA</td>
<td>3,895</td>
</tr>
<tr>
<td>EBITA Margin</td>
<td>4.1%</td>
</tr>
<tr>
<td>Less: Royalty for use of Trademark</td>
<td>0</td>
</tr>
<tr>
<td>Adjusted EBITA</td>
<td>3,895</td>
</tr>
<tr>
<td>Less: Income Taxes</td>
<td>1,558</td>
</tr>
<tr>
<td>Debt Free Net Income</td>
<td>2,337</td>
</tr>
<tr>
<td>Debt Free Net Income Margin</td>
<td>2.5%</td>
</tr>
<tr>
<td>Contributory Asset Charges</td>
<td></td>
</tr>
<tr>
<td>Normal Working Capital</td>
<td>(684)</td>
</tr>
<tr>
<td>Property, Plant &amp; Equipment</td>
<td>(238)</td>
</tr>
<tr>
<td>Workforce</td>
<td>(95)</td>
</tr>
<tr>
<td>Return on Supporting Assets</td>
<td>(1,017)</td>
</tr>
<tr>
<td>Return on Supporting Assets Margin</td>
<td>-1.1%</td>
</tr>
<tr>
<td>Net After Tax Cash Flows</td>
<td>1,321</td>
</tr>
</tbody>
</table>
Summary of Methods: With-and-Without Method

- Value of business/entity with customer relationships
- Less: Value of business/entity without customer relationships, where customer relationships are re-created
- Equals: Value of the customer relationships

- Best used when:
  - Customers are NOT the primary assets or
  - Customer relationships can be re-created
  - Time to re-create the customer relationships is short and does not change the structure of the business
Cost Approach – Overview

- Premise is that a prudent investor would pay no more for an asset than the amount for which the utility of the asset could be replaced.
- May be appropriate when the customer related asset isn’t the primary asset and can be recreated in a short period of time.
- Time to recreate is critical – if time is significant may point to a value greater than an accumulation of costs.
- May be used for early-stage companies that are unable to forecast revenue with reasonable certainty or when other approaches are difficult or not possible.
Cost Approach – Costs

Direct Costs
Plus: Indirect costs
Plus: Developer’s profit – Reflects the expected return on the investment. Should be a reasonable profit margin based on market inputs.
Plus: Opportunity costs – Profits lost while the asset is being created. Based on a reasonable rate of return on the expenditures while asset is being created. Applicable if asset cannot be used while being created.
Equals: Value of customer relationships

Taxes – Not tax affected. It is believed market participants view expenses on a pre-tax basis.
## Cost Approach – Example

### Direct & Indirect Costs

<table>
<thead>
<tr>
<th>Description</th>
<th>Cost</th>
<th>% of Total Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct Costs</td>
<td>15.0</td>
<td>55.8%</td>
</tr>
<tr>
<td>Indirect Cost</td>
<td>6.0</td>
<td>22.3%</td>
</tr>
<tr>
<td>Total Costs</td>
<td>21.0</td>
<td></td>
</tr>
</tbody>
</table>

### Developer's Profit

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
<th>% of Total Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Developer's Profit Margin (1)</td>
<td></td>
<td>20%</td>
</tr>
<tr>
<td>Developer's Profit</td>
<td>5.25</td>
<td>19.5%</td>
</tr>
</tbody>
</table>

### Opportunity Cost

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
<th>% of Total Value</th>
</tr>
</thead>
<tbody>
<tr>
<td># of Customers</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Average Lead Time (Months)</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Required Return</td>
<td>12%</td>
<td></td>
</tr>
<tr>
<td>Investment per Customer (2)</td>
<td>0.021</td>
<td></td>
</tr>
<tr>
<td>Opportunity Cost per Customer (3)</td>
<td>0.00063</td>
<td></td>
</tr>
<tr>
<td>Total Opportunity Costs (4)</td>
<td>0.630</td>
<td>2.3%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
<th>% of Total Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Cost</td>
<td>26.880</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

### Calculations

1. \( \frac{\text{Cost}}{1 - \text{Margin}} \times \text{Margin} \) such that the margin earned is 20%.

\[
\text{Profit} / (\text{Revenue}) = \frac{5.25}{(21.0 + 5.25)} = 20\% \text{ margin.}
\]

2. Total Costs / # of Customers

3. Lead Time in Years * Required Return * Investment per Customer

4. Opportunity Cost per Customer * # of Customers
## Valuation Methodology Selection

<table>
<thead>
<tr>
<th>Valuation Techniques</th>
<th>Pros</th>
<th>Cons</th>
<th>Best Used When</th>
</tr>
</thead>
</table>
| MPEEM                | - Consistent with PFI  
- Assumptions / inputs available | - Large number of assumptions needed, i.e. LTGR, attrition rate, other | - Customers are the primary asset of the business  |
| distributor Method   | - Inputs are available  
- Reduces reliance on CACs  
- Some portion of goodwill not included in value  
- Allows use of MPEEM to value primary asset | - Market inputs can be subjective and require valuer judgment  
- Requires availability of appropriate market inputs. | - Customers are not the primary asset                |
| With-and-Without Method | - Underlying theory is intuitive                                             | - Key assumptions are very subjective and difficult to support                                | - Customers are not the primary asset                |
| Cost Approach        | - Objective, if good data is available  
- Goodwill not included in value estimate | - Data difficult to find  
- May understate the value | - Customers are not the primary asset and cost data is readily available |
Customer Assets Evolve Out of other Activities

Diagram:
- Customer Relationships
  - Brands
  - Technology (including R&D)
  - Customer Service
  - Quality Control
  - Sales & Marketing
  - A&P

American Society of Appraisers
Providing Value Worldwide
Valuation Methodology Selection

- Method selection can be difficult
- The cost approach may not capture all future benefits
- The with and without method requires a significant number of inputs which are typically subjective
- The income approach methods tend to be the most commonly used methods in valuing customer relationships
- Value is based on the present value of expected future cash flows attributable to the asset being valued
- Three primary factors
  - Cash-Flow
  - Life
  - Discount Rate
Case Study 1 – Consumer Branded Product Company

**Acquirer** – Large publicly-held food & beverage producer

**Target** – Leading producer of branded snack products in the Southeast. Founded in 1905, its brands are iconic in the region.

**Rationale** – Leading brands, immediate entry into region, ability to expand distribution, significant cost synergies, prevent another firm from acquiring.
Case Study 1 – Consumer Branded Product Company

<table>
<thead>
<tr>
<th>Approach</th>
<th>Use?</th>
<th>Rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income – MPEEM</td>
<td>No</td>
<td>The brands are the most important asset, use of the MPEEM with market observations for TM Royalty Rates could understate the value of the brands and overstate the value of the Customer Relationships</td>
</tr>
<tr>
<td>Income – Distributor Method</td>
<td>Yes – Primary Method</td>
<td>This method accurately reflects the relative importance of the Customer Relationships as a business function.</td>
</tr>
<tr>
<td>Cost</td>
<td>No</td>
<td>Customers were developed in the course of business over a substantial period of time. Estimating the cost is viewed as speculative.</td>
</tr>
<tr>
<td>Income – With and Without</td>
<td>Yes – Supporting Method</td>
<td>This method indicated a value indication similar to the distributor method. However, similar to the cost approach, the inputs were more subjective. As such, it was used as a supporting/corroborating indication.</td>
</tr>
</tbody>
</table>
Case Study 2 – Government Contractor

**Acquirer** – Mid-cap, publicly traded, government contractor providing IT services to the federal government.

**Target** – Provider of IT services to certain intelligence entities

**Rationale** – Established relationships with agencies and departments with the US military and defense community and a highly qualified workforce of engineers and programmers with clearances.
Case Study 2 – Government Contractor

<table>
<thead>
<tr>
<th>Approach</th>
<th>Use?</th>
<th>Rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income – MPEEM</td>
<td>Yes</td>
<td>The customer relationships, in conjunction with the workforce, are the most important asset of the business. The MPEEM, including a CAC for the Workforce, was used.</td>
</tr>
<tr>
<td>Income – Distributor Method</td>
<td>No</td>
<td>This method would understate the value of the customer relationships as there are no other intangible assets that appear best valued using the MPEEM.</td>
</tr>
<tr>
<td>Cost</td>
<td>No</td>
<td>The cost would likely understate the value as the benefit derived from the relationship is in excess of the effort invested in explicit costs.</td>
</tr>
<tr>
<td>Income – With and Without</td>
<td>No</td>
<td>Given that the company essentially consists of customer relationships, it would be highly speculative to estimate the financial performance of the business absent customer relationships</td>
</tr>
</tbody>
</table>
Case Study 3 – Packaging Solutions Provider

**Acquirer** – PE firm in conjunction with management.

**Target** – Leading regional provider of packaging solutions.

**Rationale** – Target is a well-run, mid-size company; leader in its region; strong reputation; customer relationships are stable and highly recurring.
## Case Study 3 – Packaging Solutions Provider

<table>
<thead>
<tr>
<th>Approach</th>
<th>Use?</th>
<th>Rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income – MPEEM</td>
<td>Yes</td>
<td>The established and recurring customer relationships are a key business driver. The MPEEM, inclusive of appropriate CACs for the workforce, trademark and proprietary technology accurately values the customer relationships.</td>
</tr>
<tr>
<td>Income – Distributor Method</td>
<td>No</td>
<td>Given the importance of the customer relationships, the distributor method could understate their contribution as a business driver.</td>
</tr>
<tr>
<td>Cost</td>
<td>No</td>
<td>Customers were developed in the course of business over a substantial period of time. Estimating the cost is viewed as speculative.</td>
</tr>
<tr>
<td>Income – With and Without Supporting Method</td>
<td>Yes – Supporting Method</td>
<td>This method indicated a value indication similar to the distributor method. However, similar to the cost approach, the inputs were more subjective. As such, it was used as a supporting/corroborating indication.</td>
</tr>
</tbody>
</table>
Case Study 4 – Hardware Company

**Acquirer** – Publicly-traded company focusing on developing hardware and software products

**Target** – Leading provider of hardware components which other manufacturers integrate into assembled systems.

**Rationale** – Strong existing technology platform and development platform as well as ongoing and recurring purchases by customers.
Case Study 4 – Hardware Company

<table>
<thead>
<tr>
<th>Approach</th>
<th>Use?</th>
<th>Rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income – MPEEM</td>
<td>No</td>
<td>The intangible assets of primary importance are technology and IPR&amp;D. The MPEEM was used to value these.</td>
</tr>
<tr>
<td>Income – Distributor Method</td>
<td>No</td>
<td>Given the importance of the customer relationships, the distributor method appears to understate their contribution as a business driver.</td>
</tr>
<tr>
<td>Cost</td>
<td>No</td>
<td>Customers were developed in the course of business over a substantial period of time. Estimating the cost was viewed as speculative.</td>
</tr>
<tr>
<td>Income – With and Without Supporting Method</td>
<td>Yes – Supporting Method</td>
<td>Given customers’ need for the products provided, management could accurately project the time to recreate the customer base.</td>
</tr>
</tbody>
</table>
Comments with Substantial Disagreement

Should the MPEEM (almost) always be used?

**Yes:** Subject entity financial performance is due to the assets in place.

**No:** Often performance is explained in part by aspects for which there is no identifiable intangible – scale, location, manufacturing expertise, other.
## Assessment of Use of MPEEM

<table>
<thead>
<tr>
<th>Aspect</th>
<th>Yes MPEEM</th>
<th>No MPEEM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Valuation Methodologies</td>
<td>Most assets are valued via a “direct” approach (cost, relief from royalty, other) and one asset is valued via the MPEEM.</td>
<td>All assets are valued via a “direct” approach. The MPEEM is not used to value an asset.</td>
</tr>
<tr>
<td>Value Impact</td>
<td>Would tend to lead to a higher value as all “excess” profit is attributed to an asset.</td>
<td>Would tend to lead to a lower value as assets are individually valued.</td>
</tr>
<tr>
<td>Pro</td>
<td>All cash flow is accounted for. To the extent that elements of goodwill are ascribed to an asset, it’s directionally appropriate as it’s the most important asset.</td>
<td>Value drivers that are not identifiable intangibles (scale, location, manufacturing expertise, industry structure, other) are excluded from the value of intangible assets.</td>
</tr>
<tr>
<td>Con</td>
<td>May overstate the value of identifiable intangible assets.</td>
<td>May understate the value of identifiable intangible assets. The valuation of each intangible has a substantially greater impact as no asset receives the residual.</td>
</tr>
</tbody>
</table>
What is the appropriate framework for thinking about the value of customer relationship in a PPA?

a) TM/Tech valued based on market royalties and all residual income allocated to CR

b) TM/Tech valued based on contribution (simulated royalty rates) with residual income allocated to CR

c) TM/Tech valued based on market royalty rates. CR valued using a direct approach i.e. approach other than an MPEEM
Determining the cash flow related to customer relationships is difficult and is the input that has the biggest impact on customer value.

**Manufacturing**

**Sales & Distribution**

**Intellectual Property**
Comments/Questions

- Customer value is minimal is most situations. Why would customers pay a premium? CRA is not controlled and is the result of other activities.
- Can the distributor method be used in all situations? Why should the MPEEM be used to value another asset?
- Should the distributor method be used only in situations where products are distributed by a distributor?
- Is there an industry bias to using the MPEEM to value CRA?
- What happens in situations where customer data shows no attrition?
- The discount rate cannot offset forecast risk relating to margin expansion
Conclusions

• Valuation methods converge
• Valuing CRA is not a mechanical process; it requires thought, qualitative and quantitative analysis
• Different schools of thought remain
• Best practices continue to evolve
Questions??