Globalview Advisors

Financial Valuation and Advisory Services

Irvine • Los Angeles • Boston • London

19900 MacArthur Boulevard, Suite 810
Irvine, California 92612
T: 949.475.2800 F: 949.475.2580
www.globalviewadvisors.com

January 14, 2014

Via email: paula@appraisalfoundation.org

Working Group 2 - The Valuation of Customer-Related Assets
c/o Ms. Paula Douglas Seidel
The Appraisal Foundation
1155 15th Street NW, Suite 1111
Washington, DC 20005

Re: The Valuation of Customer-Related Assets ("CRA") Exposure Draft
Comments from Globalview Advisors LLC

Dear Ms. Seidel:

The valuation professionals at Globalview Advisors LLC appreciate the efforts of The Appraisal Foundation and its staff, the members of the working group and subject matter expert group and others participating in the development of the exposure draft entitled "The Valuation of Customer-Related Assets." This is an important endeavor. We believe the exposure draft meaningfully advances the understanding of this topic and that any divergence in practice in developing valuations and the resulting valuation estimates will be reduced.

Globalview Advisors is pleased to provide comments on the CRA Exposure Draft as follows.

1. *Page 8, Lines 270 to 275* – Some practitioners use the terms customer list and customer relationship interchangeably. Adding examples of customer lists in this section will enhance reader understanding of this type of customer-related asset.

   The text refers to customer lists that are leased or exchanged. Examples of each of these at this point in the text would enhance understanding of this concept.

2. *Page 8, Lines 288 and 289* – Additional language on unfavorable customer contracts that constitute a liability would help improve practitioner understanding.

   Also, a discussion of whether and when unfavorable customer-related assets can or cannot be netted against "favorable" contracts for financial reporting purposes would increase practitioner awareness of this important consideration.

3. *Page 10, Line 375* - Suggest replacement of "assets" with "different assets".

4. *Page 10, Lines 379 and 380* – As written, the sentence might lead some to construe that an entity that is not generating revenues does not meet the definition of a business. Suggest modification of this language.

5. *Page 11, Line 406 and 407* – May want to restate "In the absence of choice . . ." as "In the absence of choice of providers . . ." This would help clarify that the choice is that of the prospective customer.

6. *Page 12, Line 474 and 475* – The analysis of purchase-order vs. long term contracts may lead to the determination of whether there is a potential customer relationship to follow a customer contract. Suggest revision of last sentence to "This analysis may impact choice of model, likelihood of a customer relationship subsequent to the expiration of the contract term, attrition assumptions, and other valuation inputs."

7. *Page 13, Line 518 to 525* – Might consider adding language as follows "Distributors are typically low value added providers with limited intangibles and low profit margins. As such, the profit margins of a distributor would be expected to require fewer adjustments to estimate the profit margin of low value added customer relationships as other intangible assets would not be expected to impact profit margins."

8. *Page 13, Line 522* May consider adding the following sentence - "Where intangibles such as strong brands or unique, high value technology are driving customer demand and customer specific efforts are limited, the Distributor Method may be an appropriate means of valuing customer-related intangibles."

9. *Page 14, Line 548 and 549* – Language could be construed to suggest that opportunity costs are measured as of the time of creation of customer relationships rather than creation as of the valuation date. Also, the reference to foregone cash flows suggests a lost profits based model (WWM) rather than opportunity costs as a return based concept.

10. *Page 14, Line 553* – Should there be a specific reference to the MPEEM? What other methods would be used?

11. *Page 15, Line 573* – Suggest expansion of the explanation to clarify the statement that transactions are not observable. A first factor should probably be the transactions don't occur or if they do occur, it is very infrequent for most industries. The second factor would be if they do occur, observable data on the transaction typically isn't available.

12. *Page 15, Line 587 and 588* – Bullet "a" indicates "cash flows applicable to the asset". This captures both the amount and the duration. This could suggest that bullet "b" isn't necessary. Bullets "a" and "b" could be combined into one slightly expanded bullet.

13. *Page 16, Line 592* – Rather than stating projected cash flows are estimated shouldn't the reference be to projected residual income (excess earnings) to be more accurate? The term cash flows might suggest releases of working capital due to customer revenue declines are includable in the benefit stream to be valued. This is not the case.

14. *Page 17, Line 646 and 647* – Adding language here or elsewhere that existing customer revenues are a result of changes in selling price ("P") or quantity purchased ("Q") from existing customers may help practitioners better address growth estimates.

    Also, language noting that growth of existing customer revenues (as a percent) would often be expected to be less than the growth of company total revenues may be helpful to practitioners. This is due to company revenues frequently growing due to increases in the total number of customers as new customer additions are forecast to exceed existing customer losses.

15. *Page 17, Line 651* – Revise "many years" to "as many years".

16. *Page 18, Line 662* – Suggest deletion of the word "common". For line 663, may wish to change "are" to "include".

17. *Page 17, Line 669 and 670* – Truncation points of 90, 95 and 99% compared to truncation points of 1, 2 or 3% appear inconsistent.

    Generally, there shouldn't be significant effort associated with using a truncation point of 1% for projected economic benefits compared to a truncation point of 10% (100% less 90%). The amortization life (and pattern) is a separate but related accounting determination. The change in the truncation point should not impact the amortization assessment and determination is the present value of cash flows is appropriate considered.

18. *Page 19, Line 692* – Replace "determining" with "estimating".

19. *Page 19, Line 704* – Change "comparable" to "representative".

20. *Page 20, Line 707* – For the historical population revenue row, expanding discussion in the text that including revenue gains and losses from existing customers could suggest growth may not be includable in projections of future revenue from existing customers may be helpful to practitioners.

    Expanded language to help insure practitioners do not double count revenue growth by including growth in the attrition calculation and the existing customer revenue estimates before attrition would be helpful to practitioners.

21. *Page 21, Line 726* – Further discussion of whether the target or the acquirer's attrition is most appropriate might be helpful. If there are multiple strategic buyers with existing operations, it could be a market participant assumption to use the acquirer's attrition as this is their expectation. (This may be difficult to assess as being a market participant assumption as attrition expectations of other buyers may not be observable.)

22. *Page 21, Line 732* – Discussion of whether a constant percentage attrition rate or a variable attrition rate should be used would be helpful to practitioners.

23. *Page 21, Line 736* – Rather than "vintages" why not say "age groups"? This would likely increase reader comprehension.

24. *Page 21, Line 754* – May want to add that efforts to quantify the attrition estimate should be considered.

25. *Page 29, Line 1075* – Replace "the following factors should be considered" with "factors including the following should be considered". This change would help users think more broadly of factors that may be relevant for consideration.

26. *Page 30, Line 1094* – Could an example on new customer vs. existing customer support efforts be added? This may help users better understand the concept.

27. *Page 30, Line 1104 and 1105* – The sentence beginning "As the time period . . ." is an important concept that might be better towards the front of the WWM section. This relates to the question of what the primary asset is if the replacement period for customers is long and the potential foregone profits are significant.

28. *Page 30, Line 1118 and 1119* – Might mention the preference for capturing risk in the cash flows being modeled rather than in an adjustment to the WACC.

29. *Page 35, Line 1174* – The long period to replace would suggest the need to include opportunity costs in the valuation.

30. *Page 35, Line 1189* – Delete "and inputs". Suggest revision to "facts and circumstances and appropriate valuation methodology for the valuation of the customer-related assets.

31. *Page 36, Line 1199* – A discussion of possible justifications for value of the customers given negative cash flow expectations would seem to be in order. Negative cash flows typically suggest high levels of economic obsolescence.

32. *Page 36, Line 1227* – The comment on inefficient efforts should be further clarified. In theory, all efforts that don't result in obtaining a customer could be viewed as inefficient but these "dry holes" are frequently necessary.

33. *Page 37, Line 1243 and 1244* – The list of items for calculating opportunity costs "(measured as returns, profits, cash flows, or a similar metric)" is somewhat confusing. Suggest language be revised to be more specific.

34. *Page 37, Line 1247 and 1248* – Inclusion of developers profit in the opportunity cost mark-up should be further assessed. If an opportunity cost of capital, then it would seem that developers profit is not includable as it isn't a capital cost.

35. *Page 37, Line 1249* – Reference to "other assets" requires further clarification.

36. *Page 37, Line 1252 and 1253* – This section presents opportunity costs as either: 1) Opportunity cost of capital or 2) lost profits. May want to mention these two elements at the very start of the opportunity cost section (line 1248)

Globalview Advisors

37. *Page 37, Line 1260 and 1261* – Some practitioners believe that developers profit is captured in the mark up on costs. For an asset that is sold, presumably once you have sold enough units, you will generate a return on the capital invested. May wish to expand the explanation of developer's profit. It is harder to grasp than the opportunity cost of capital.

38. *Page 37, Line 1271* – The text references "owners required return or demonstrated historical return". Should language be added to insure that these are consistent with a market participant perspective?

39. *Page 37, Line 1270 and 1271* – Given the limited guidance on economic obsolescence in general, further expansion of these comments (and a possible example) would be merited.

40. *Page 37, Line 1272* – The need to consider obsolescence (both age/life (see subsequent comment) and economic) in the application of the Cost Approach to value and challenges with measuring opportunity costs suggest higher degrees of uncertainty in certain instances when the Cost Approach is applied. Given these uncertainties, the Distributor Method could be a viable alternative to the Cost Approach.

41. *Page 38, Line 1275* – Text indicates that amounts should be pre-tax. Does this hold for the opportunity cost which is measured as lost profit?

42. *Page 38, Line 1291* – May wish to discuss the concept of age / life depreciation. If a customer is halfway through their lifecycle, wouldn't the shorter remaining life merit a downward adjustment relative to an otherwise identical new customer with a longer expected remaining life?

43. *Page 39, Line 1293* – Expanding the calculation (and various subsequent calculations) will help readers better understand the logic of the calculations. Opportunity cost part of table is somewhat hard to follow.

44. *Page 40, Line 1307* – The text suggest that "subscriber lists, or frequent flyer/shopping lists" are sold. Does this mean they are sold with all rights moving to the buyer or is the seller merely providing a non-exclusive right to use? May wish to expand this section to clarify.

45. *Page 40, Line 1314* – A customer list rental rate might differ significantly from the value of a customer relationship (i.e., value of a group of customers representing magazine subscribers compared to the income from selling a right to use the names for a limited

period in a possibly limited market). Further discussion on how this rental rate could serve as a basis for valuation would seem appropriate.

46. *Page 42, Line 1371 and 1372* – Does the reference to a three year term suggest a "bright line" for use of the WWM?

47. *Page 42, Line 1384 and 1385* – Earlier example had cost savings over 5 years. Another example suggested short is 3 years. May want to revise this language or the prior example to avoid any confusion.

48. *Page 42, Line 1400* – Rather than state "inconsistencies with other approaches", it might be better to include a few specific examples.

49. *Page 43, Line 1423* – The life of order backlog and customer relationships would seem to frequently be different. To include this as a reason for separate valuation does not seem appropriate.

50. *Page 44, Line 1467* – Language on what constitutes a customer could be helpful to users. In certain cases, there may be multiple buyers of a product or service at a specific firm and these might possibly be considered as one customer, whereas, in reality, there are several separate customers at the same company.

51. *Page 46, Line 1553* – Expanded discussion of whether growth has been separated from the attrition estimate may be merited. The sentence suggests attrition is offset by growth. A more insightful form of calculation would present revenues without attrition but including growth and then follow this with attrition calculations. This would suggest revision to the sentence.

52. *Page 48, Line 1583 and 1584* – As written, the sentence would seem to suggest that life could be correlated to the "historical expense or cost pattern" in certain instances. This would not seem to be expected. Given this, revision of the sentence to avoid this possible inference is suggested.

53. *Page 61, Line 1930* – May wish to clarify that "revenue losses with attrition" are measured as percent of base year in a footnote.

Globalview Advisors

54. *Page 61, Line 1937* – A MPEEM example showing separate revenue growth and attrition estimates could be helpful to readers.

55. *Page 64, Line 1979* – Rather than "survival vintage year" can an alternative term such as "age" be used? This might increase user understanding.

56. *Page 64, Line 1980* – Suggest replacing "to inform" with "to estimate".

57. *Page 65, Line 2001* – A reference for further reading on the Weibull distribution curve might help readers.

58. *Page 67, Line 2028* – A simpler, more intuitive presentation would be:

    Revenues without attrition as the top row (including growth),
    Attrition factors
    Revenues after attrition.

59. *Page 72, Line 2128* – Delete reference "company specific".

60. *Page 73, Line 2139* – Including a row for marketing costs avoided might be helpful to remind readers of this possible adjustment.

61. *Page 74, Line 2172* –US government agencies and departments are generally required to competitively bid contracts. This would seem to weaken the case for a possible customer relationship value above and beyond a "base" contract value. Further discussion of this may be helpful to users.

62. *Page 75, Line 2208* – Replace the word "approach" with "method".

63. *Page 76, Line 2219* – Might want to add language that historical levels are believed to be consistent with market participant expectations for future levels.

64. *Page 81, Line 2342* – To the extent a WWM is used rather than the Distributor Method, some justification for the selection would be in order. Presumably, this would relate to a short period to re-create.

65. *Page 83, Line 2348* – To assist in the justification, further information such as the value of technology might be helpful to provide context. Isn't reasonableness really a function of determining the appropriate method and then appropriate inputs?

66. *Page 84, Line 2351 and 2352* – Further clarification on how factors "b" and "c" provide comfort in the amount of value allocated to the customers would be helpful to readers.

Thank you for the opportunity to provide these comments. Please contact me at 949 475-2808 or rrath@globalviewadvisors.com with any questions.

Sincerely,

GLOBALVIEW ADVISORS LLC

Raymond Rath

Raymond Rath, ASA, CFA
Managing Director