Intangible Asset Valuation:
The Distributor Method

RAYMOND D. RATH,
ASA, CFA

Globalview Advisors
Irvine, CA
rrath@globalviewadvisors.com

The Appraisal Foundation's release of the June 5, 2012 discussion draft on "The Valuation of Customer-Related Assets" (CRA Draft) was an important development for the valuation profession. For appraisers with an interest in the valuation of intangible assets for financial reporting purposes, the document requires a thorough review as many important areas are discussed. Despite its financial reporting focus, the draft includes many useful insights for general business appraisers. These include useful discussion of factors influencing customer value and the relationships of different intangible assets and their contributions to overall business profitability. The draft reminds appraisal professionals of the importance of technical competency and ethical behavior (Section 1.1.5). While the guide provides appraisers with best practices, the guide notes, "facts and circumstances related to the asset(s) that are being valued may support a departure from the recommendations of this document." (CRA Draft, pg. iv).

For many intangible asset appraisers, the language describing and explaining the application of the Distributor Method (DM) for the valuation of customer-related assets (CRA) has been long-awaited. While members of the CRA working group established by The Appraisal Foundation have made several presentations on the DM prior to the release of the CRA Draft, the CRA Draft provides important additional insights for valuation professionals. This article will highlight several key issues in the selection and application of the DM.

OVERVIEW

The DM is essentially "shorthand" for the valuation methodologies for several different intangibles of an acquired business enterprise. Using the DM, technology, a brand or another asset other than a CRA is determined to be the primary asset of an enterprise and is valued using a multi-period excess earnings method (MPEEM). (Per Section 3.3.5, ". . . a primary asset of a business is an asset which has significant importance to the business relative to other assets and is a key business driver from an economic perspective [e.g., cash flows]".) Under the DM, CRA are determined to be a secondary asset and are valued using a discounted cash flow model. A royalty rate for the CRA is developed based on the profit margins of distribution companies. The royalty rate includes a downward adjustment for contributory asset charges.

ADVANTAGES OF THE DISTRIBUTOR METHOD

The CRA Draft notes advantages of the DM. Further assessment notes other advantages associated with the DM. A brief discussion follows.

Uses Market Evidence for CRA Valuation

One advantage of the DM for the valuation of CRA is the use of market evidence to develop the expected return from customers (Section 5.3.1). Estimating a market return for CRA is discussed in a subsequent section of this article.

Avoidance of CRA Valuation Methods with Subjective Estimates

Alternative approaches for the valuation of CRA's include the cost approach and the With-and-Without Method (WWM). Application of the cost approach includes challenging assumptions with limited market evidence to support. These subjective estimates include:

1) appropriate cost elements to include (What overhead expenses should be allocated as an example?)
2) the amount of these costs (What period of time is required to develop the CRA? How is obsolescence estimated?)
3) whether entrepreneurial profit and/or opportunity costs should be considered. The WWM requires very subjective estimates for the period required to replace CRA and their rate of replacement (straight line, step function, other) as well as the level of costs required.

Avoidance of Technology Valuation Methods with Subjective Estimates

For companies with technology as a primary asset, the DM allows for the valuation of CRA using a Relief-from-

Continued on next page

expert TIP

The language describing and explaining the application of the Distributor Method (DM) for the valuation of customer-related assets (CRA) in the Appraisal Foundation's discussion draft on "The Valuation of Customer-Related Assets" has been long-awaited.

Royalty Method (RFR method). More importantly, use of the DM for CRA allows technology to be valued using a MPEEM. Meaningfully comparable market evidence for royalty rates for technology is very difficult to obtain. Also, the Profit Split Method has been discredited in several recent civil court cases. As these factors raise questions on the RFR method to value technology as a primary asset, the DM effectively eliminates the risk of reliance on a royalty rate estimate for an enabling technology or brand if a RFR method is used rather than an MPEEM.

Considers Economic Benefits of CRA
In addition to the challenges associated with the Cost Approach and WWM noted above, these methods do not directly consider the future economic benefits derived from CRA. The DM appropriately captures the expected future economic benefits of the CRA through the application of a royalty rate based on CRA profitability and attrition-adjusted future revenues.

Reduced Risk of Mis-valuation of CRA
Another advantage of the DM is the avoidance of complex methods that are occasionally used in situations where technology *and* CRA's are both previously viewed as primary assets. The correct allocation of "shared" profit between the two primary assets was an area of lengthy discussions within the profession. Guidance on these complex methods is modest and their complexity may possibly raise undue cost and burden arguments in certain instances.

DISTRIBUTOR METHOD INPUTS

The CRA Draft discusses the derivation of various inputs for the CRA valuation model. A few of these where additional consideration is appropriate are summarized below.

Royalty Rate (Profit Margin of Distributors)
The DM essentially develops a royalty rate (distributor profit margin adjusted downward for the contributory asset charges of a distributor) (see Section 4.2.5). Using distributor inputs directly isolates the cash flow attributable to the CRA. Discussion of several means of developing the CRA profit margin follows.

Guideline Companies
(Sections 5.3.3 and 5.3.5)
The CRA Draft notes that profit margins of publicly traded distribution companies in the same industry are the best source of profit margins for CRA valuation (Section 5.3.3 indicates the difference in profit between IP companies and non-IP companies in a specific industry). Given the nature of U.S. equity markets, we would expect a very limited pool of low value-added public companies such as pure distributors. Assessment of the universe of guideline public companies (GPC) confirms this expectation.

In the absence of GPC in the subject industry, the available pool of GPC in all industries as well as profit margins of privately held distributors may provide useful insights. While private company data can be difficult to obtain, management or industry sources may provide helpful insights for the profitability of a distribution company. As a distributor holds very limited intangible assets, the private market would seem to have many more entities that are "pure" distribution companies that would provide evidence of the profit of this business function.

Private Label Sales
A company may sell unbranded products to third parties. The profit margin associated with these private label sales could approximate the return of a firm with limited intangible value. Factors such as the consistency of private label sales volumes and the related profit margins should be carefully assessed to confirm the reasonableness of this possible evidence. As private label sales could reflect opportunistic sales in the very short term to avoid unused capacity, this data should be considered with special care. (Section 5.3.3)

Contributory Asset Charges (CAC)
CAC should be included in the valuation of CRA using the DM. In addition to using a distributor profit margin, the CAC should reflect the expected investments required in different contributory assets of a distributor. Brief comments on the different contributory assets follow.

- Working Capital (WC) – Charge for WC would often be expected to be modest. Distributors often have rapid turnover reducing the amount of required investment. The risk of accounts receivable and inventory are typically low which would reduce the return requirement.
- Fixed Assets (FA) – Charge for FA is expected to be low. Distributors do not perform manufacturing functions and no manufacturing assets would be expected. The warehouse is likely rented and included in operating expenses. Other FA are expected to be very modest. Risk of this asset category is also expected to be modest given the non-specialized nature of the fixed assets.
- Technology – Technology held by the firm manufacturing the product and included in the sales price to the distributor. As a result, return on technology is included in the cost of goods sold of the distributor. No CAC for technology would be expected.
- Trade (brand) name – Trade name or brand value is typically associated with the product obtained from a third party. Trade / brand name value is included in the cost of goods sold of the distributor (amount paid to the supplier). No CAC for trade name would be expected. While the acquired company obviously holds either technology or a brand that is a primary asset, the use of distributor profit margins eliminates any need for a charge for a trade name for the CRA valuation.

Continued on next page

WACC

The CRA Draft also notes possible differences in the WACC of a distributor (see Section 5.3.9) and the acquired company with a broader base of operating functions. The CRA Draft notes there is limited data to calculate a WACC for distributors and states the distributor's WACCs may be ". . . viewed as an additional or corroborating input rather than a primary input."

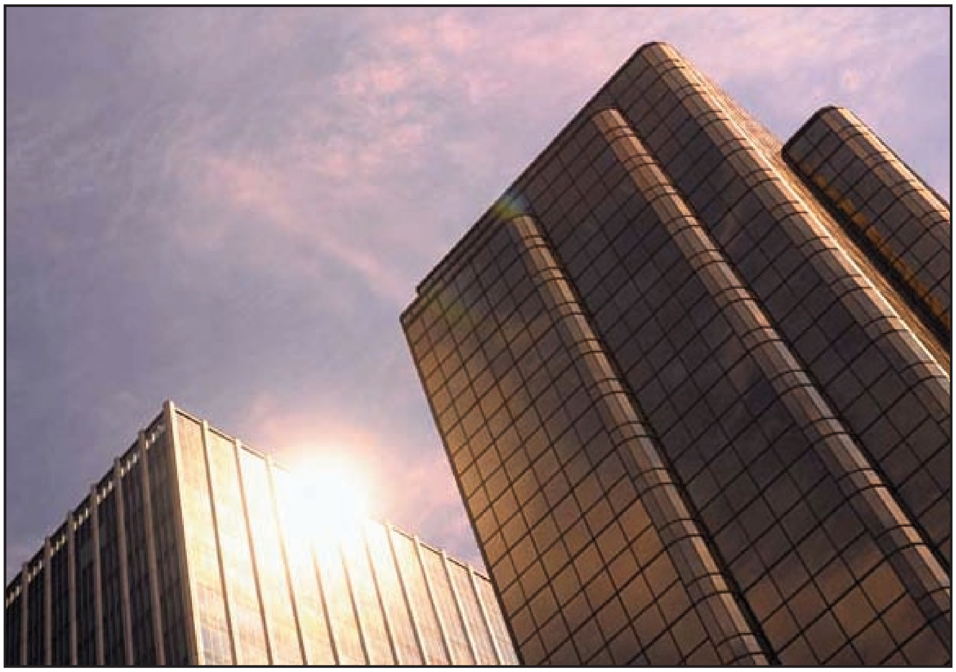
WHEN TO USE

Presently, the DM is most frequently observed in situations where a brand is the primary asset. It will be interesting to see if language in the draft expands the application of the DM for situations with other primary assets (i.e., technology). As noted at Section 3.3.5 ". . . a primary asset of a business is an asset which has significant importance to the business relative to other assets and is a key business driver from an economic perspective (e.g., cash flows). Depending upon the nature of the business, the primary asset(s) may be tangible assets such as real or personal property or intangible assets such as customers, technology, brands, or another asset." This sentence could suggest increased use of the DM when the primary asset is believed to be technology if CRA factors are consistent with a modest investment in CRA.

Assessment of corporate activities and spending is an important element of determining the relevance of the DM. The CRA Draft notes the determination of the valuation method is largely a qualitative process. A few brief thoughts on firms where a brand or technology may be the primary asset follow.

Brand company factors include:

1) Demand is driven by an end user rather than an intermediary (direct customer) – (see subsequent discussion)
2) Marketing efforts are focused at end users rather than direct customers
3) Customer base consists of intermediaries often with very limited attrition



4) Marketing efforts are significant relative to investments in other intangibles

Technology company factors include:

1) Customer purchase decision largely reflects assessment of the technology
2) Greatest amount of spending is on developing and maintaining technology

Please refer to Section 3.3.6 of the CRA Draft for a list of qualitative factors for assessing the relative importance of customer relationships. Detailed assessment of these factors can help in determining whether CRA are the primary asset.

Whether or not CRA meet recognition criteria is one factor in the application of the DM. Comparing the hypothetical acquisitions of Coca Cola Enterprises, Inc. and McDonald's, Inc. provides helpful insights. For both companies, the brand would obviously reflect the primary asset of each enterprise. Recognition of CRA is an area where the two firms diverge. Coca Cola's CRA include grocery stores, quick-service restaurants and a large number of other business customers. The customers would certainly meet asset recognition criteria and require valuation. For McDonald's, CRA are walk-in (retail) customers. Under current accounting guidance, these walk-in customers do not meet recognition criteria. For Coca Cola, a DM for CRA would be used with the brand valued using an MPEEM with a charge for customers. CRA would be valued using an RFR method with the royalty rate based on profit margins of distributors. For McDonald's, the brand would be also valued using a MPEEM. Customer acquisition costs (advertising) would, at least, partially be reflected in the sales and marketing expenses and therefore COGS. CRA would not be valued.

CONCLUSION

The CRA Draft is an important development that advances our understanding of customer-related assets and appropriate valuation methodologies and assumptions. In addition to advancing our thinking in the identification of primary and secondary assets of an operating business enterprise, the CRA Draft expands our recognition and understanding of the Distributor Method. As a result, intangible asset valuations should reflect improved choices of valuation methods and assumptions for the different intangible assets of an acquired company. ꟿ