Alternative Methods for Valuing Customer Relationships

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- 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.

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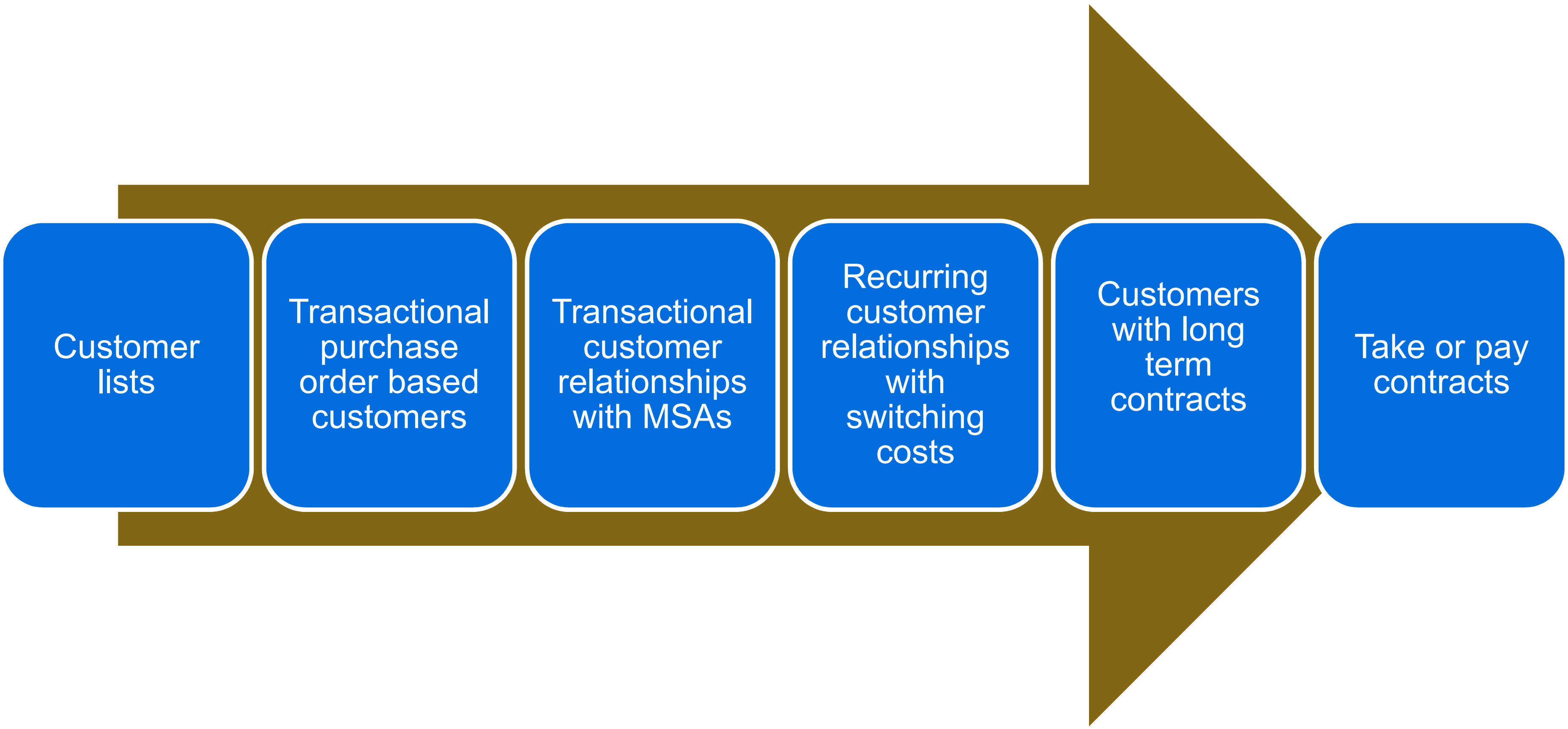
Topics Covered in the Valuation Advisory

- 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



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

Revenue Adjusted for Growth	$100,000
Remaining After Attrition	95.0%
Revenue After Attrition	95,000
EBITA	3,895
	4.1%
Less: Royalty for use of Trademark	0
Adjusted EBITA	3,895
Less: Income Taxes	1,558
Debt Free Net Income	2,337
Debt Free Net Income Margin	2.5%
Contributory Asset Charges	
Normal Working Capital	(684)
Property, Plant & Equipment	(238)
Workforce	(95)
Return on Supporting Assets	(1,017)
	-1.1%
Net After Tax Cash Flows	1,321

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		**% of Total Value**
Direct Costs	15.0	55.8%
Indirect Cost	6.0	22.3%
Total Costs	21.0	
Developer's Profit		
Developer's Profit Margin (1)	20%	
Developer's Profit	5.25	19.5%
Opportunity Cost		
# of Customers	1,000	
Average Lead Time (Months)	3	
Required Return	12%	
Investment per Customer (2)	0.021	
Opportunity Cost per Customer (3)	0.00063	
Total Opportunity Costs (4)	0.630	2.3%
Total Cost	26.880	100.0%

Calculations

1 - (*Cost / (1 - Margin) * Margin)* such that the margin earned is 20%.

Profit / (Revenue) = 5.25 / (21.0 + 5.25) = 20% margin.

2 - Total Costs / # of Customers

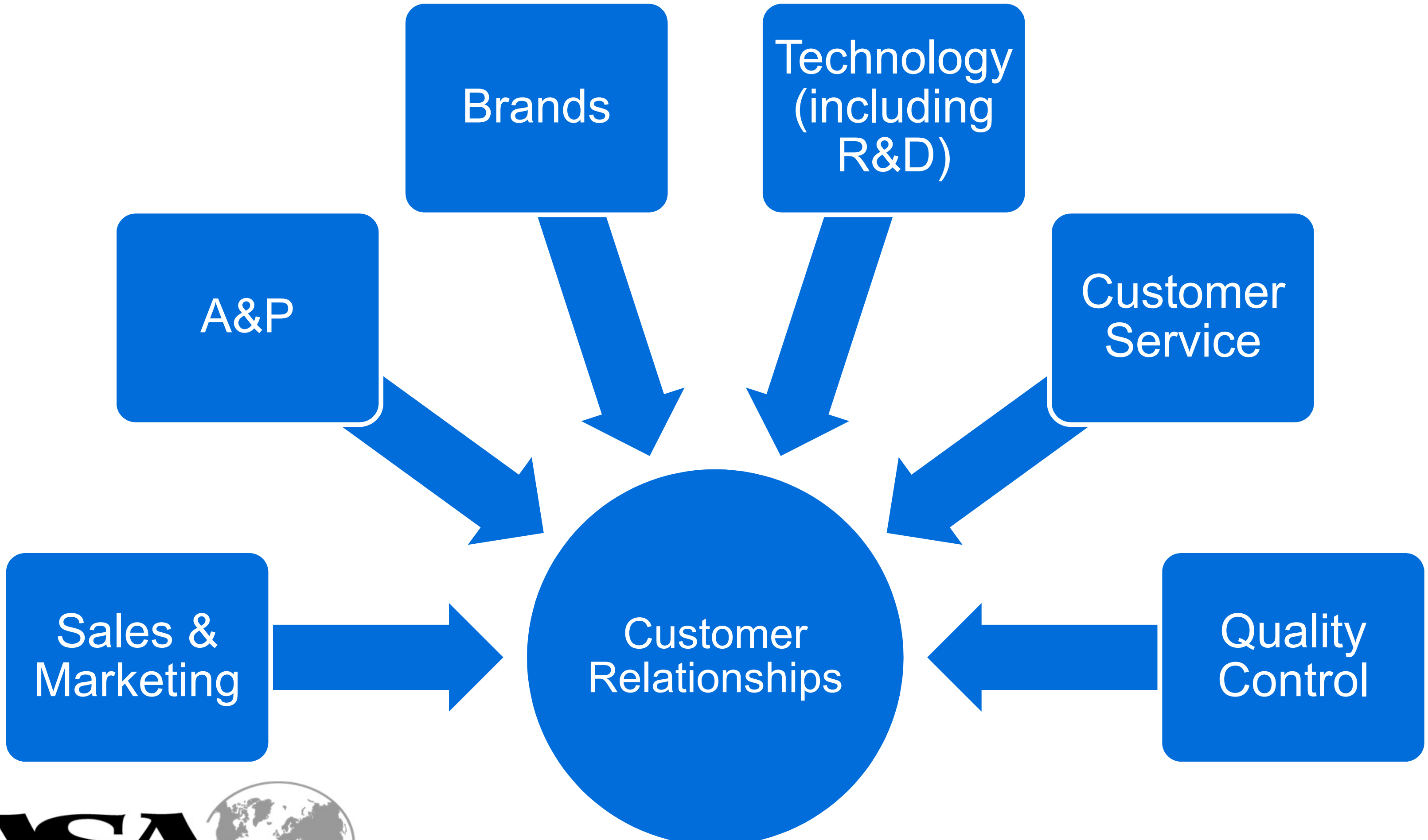
3 - Lead Time in Years * Required Return * Investment per Customer

4 - Opportunity Cost per Customer * # of Customers

Valuation Methodology Selection

Valuation Techniques	Pros	Cons	Best Used When
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



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

Approach	Use?	Rationale
Income – MPEEM	No	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
Income – Distributor Method	Yes – Primary Method	This method accurately reflects the relative importance of the Customer Relationships as a business function.
Cost	No	Customers were developed in the course of business over a substantial period of time. Estimating the cost is viewed as speculative.
Income – With and Without	Yes – Supporting Method	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.

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

Approach	Use?	Rationale
Income – MPEEM	Yes	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.
Income – Distributor Method	No	This method would understate the value of the customer relationships as there are no other intangible assets that appear best valued using the MPEEM.
Cost	No	The cost would likely understate the value as the benefit derived from the relationship is in excess of the effort invested in explicit costs.
Income – With and Without	No	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

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.

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Case Study 3 – Packaging Solutions Provider

Approach	Use?	Rationale
Income – MPEEM	Yes	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.
Income – Distributor Method	No	Given the importance of the customer relationships, the distributor method could understate their contribution as a business driver.
Cost	No	Customers were developed in the course of business over a substantial period of time. Estimating the cost is viewed as speculative.
Income – With and Without	Yes – Supporting Method	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.

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

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

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

Aspect	Yes MPEEM	No MPEEM
Valuation Methodologies	Most assets are valued via a "direct" approach (cost, relief from royalty, other) and one asset is valued via the MPEEM.	All assets are valued via a "direct" approach. The MPEEM is not used to value an asset.
Value Impact	Would tend to lead to a higher value as all "excess" profit is attributed to an asset.	Would tend to lead to a lower value as assets are individually valued.
Pro	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.	Value drivers that are not identifiable intangibles (scale, location, manufacturing expertise, industry structure, other) are excluded from the value of intangible assets.
Con	May overstate the value of identifiable intangible assets.	May understate the value of identifiable intangible assets. The valuation of *each* intangible has a substantially greater impact as no asset receives the residual.

Schools of Thought

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

What is the Appropriate Level of Cash Flow: Review Business Functions

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

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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??