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May 2019

VALUATION OF CUSTOMER RELATED INTANGIBLES

Customers are the driving force of any organization regardless of the sector in which it operates. Acquisition targets are often attractive on account of the customer loyalty they have built over the years as well as the data they possess about their customers. This newsletter discusses customer related intangible assets, the various forms in which they exist as well as methods to value them.

INTRODUCTION TO CUSTOMER RELATED INTANGIBLES

Customer related intangibles arise out of the information acquired and relationships developed through the course of repeated transactions with customers, with or without an underlying contract.

A customer related intangible is identifiable in the books of the acquirer on fulfilment of either the separability or contractual-legal criterion as stated in ASC 805: Business Combinations[1], IFRS 3: Business Combinations[2] and Ind AS 103: Business Combinations[3]. These two criteria are highlighted as follows:

- **Separability criterion**: Intangible asset is capable of being separated from the acquired company and sold or exchanged for value.
- **Contractual-legal criterion**: Intangible asset arises from contractual or other legal rights, regardless of whether those rights are in fact transferable or separable from the acquired entity.

In line with the afore-mentioned criteria, the universe of customer related intangible assets can be broadly categorized as follows:

CATEGORIES OF CUSTOMER RELATED INTANGIBLE	CRITERIA FOR IDENTIFICATION AS AN INTANGIBLE ASSET	DESCRIPTION
Customer contracts	Contractual-legal	Customer contracts are legally enforceable agreements that an entity has with its customer for supply of goods or provision of services.
Customer relationships	Separable	A customer relationship exists between an entity and its customer if the entity has information about the customer and has regular contact with the customer, and the customer has the ability to make direct contact with the entity. The nature of such a relationship is non-contractual, however, customer relationships are separable in nature, for example, when a division of one organization migrates to another, the customers serviced by that division often go with it even though there is no contractual requirement.
Customer lists	Separable	Customer lists consist of information about customers including their names, contact information, preferences and other information, that act as aid to build customer relationships. Customer lists satisfy the separability criterion as they can be easily leased or exchanged.
Order or production backlog	Contractual-legal	An order or production backlog arises from contracts such as purchase or sales orders. An order or production backlog acquired in a business combination meets the contractual-legal criterion even if the purchase or sales orders are cancelable.

[1]ASC 805: Business Combinations issued by Financial Accounting Standards Board
[2]IFRS 3: Business Combinations issued by International Accounting Standards Board
[3]Ind AS 103: Business Combinations issued by Ministry of Corporate Affairs, India

VALUING CUSTOMER RELATED INTANGIBLES

Valuation of customer related intangibles is similar to business valuation as the underlying principle is to discount the cash flows attributable to the asset to its present value. However, it differs from business valuation as the factors assessed while valuing customer related intangible are different from those that are assessed while valuing businesses.

- **INCOME APPROACH**

  - **Multi period excess earnings model ("MPEEM")**

The MPEEM is primarily used where customer related intangible is the primary intangible. The underlying fundamental of MPEEM involves isolating the entity's cash flows attributable to existing customer relationships, by adjusting them for projected customer attrition and providing for requisite charges on contributory assets. These requisite charges are known as contributory asset charges which represent the charge that is required to compensate a market participant for an investment in a contributory asset. CACs are estimated based on a rate of return on (investment return) and return of (recoupment of original investment) contributory assets.

The value of customer related intangible is the present value of such excess cash flows, discounted using an appropriate discount rate.

Non-contractual customer relationships identified as a primary intangible asset in an acquisition are valued using this method.

For an illustration of the application of MPEEM, refer our previous publication **here.**

Issues faced in valuation

- **Estimation of attrition rate:**

Attrition is the decay in the customer related intangible's contributory power to the entity's cash flows. Estimating customer attrition requires management's inputs and in the absence of the same, historical attrition data can be used as a proxy.

A lot of literature exists on sophisticated techniques to estimation of customer attrition, however in the absence of the requisite data points, the application of the techniques become difficult.

The following table illustrates estimation of attrition rate based on historical customer-wise revenue data:

PARTICULARS	YEAR -1	YEAR -2	YEAR -3
Customer 1	100	90	120
Customer 2	70		
Customer 3	75	95	
Customer 4	160	200	150
Customer 5	200	140	
Customer 6	95		
Total revenues (A) (in USD million)	**700**	**525**	**220**
Lost revenues (B)		165 [70 + 95]	235 [95 + 140]
Percentage lost (B_T/A_{T-1})		23.57%	44.76%
Average			**34.17%**

- **Estimation of contributory asset charges ("CACs"):**

Estimation of CACs entails making a number of assumptions w.r.t the requisite returns on the contributory assets for which market participant data is often unavailable. Thus, such estimation is required to be made in a vacuum without any historical data to back it up or market participant data for benchmarking.

➢ **With or without method**

Under this method two sets of cash flows are forecasted: i) assuming that the company owns the customer related intangible and benefits from it ("with scenario"), and ii) in absence of the customer related intangible ("without scenario"). The value of customer related intangible is the present value of the after-tax incremental cash flows; (i – ii). The with or without method can be used in cases where the impact of customer related intangible can be distinctly identified by decline in the cash flows.

Customer contracts, when they are not the primary intangible, are commonly valued using this method.

The key adjustments while estimating the cash flows in the without scenario are to be done in revenue, operating expenses, working capital and discount rate.

Issues faced in valuation

One of the key issues faced in the application of this method is the estimation of the financial metrics in the without scenario, especially when the contract does not specify a pre-determined level of revenue from the customer over the contractual term. Similarly, in the valuation of non-contractual customer relationships, estimating the costs required to develop the relationships is not apparent. Management inputs become critical at this juncture as the value conclusion is only as good as the inputs.

➢ **Cost savings method**

The cost savings method determines the value of a customer related intangible by computing the present value of the estimated after-tax costs avoided by ownership of the customer related intangible asset.

It is pertinent to not confuse the cost savings method with the cost approach of valuation of customer relationships. While the premise of the cost approach is based on the replacement of the existing customer relationships, the cost savings method emphasizes on future implied cost savings on account of the ownership of the asset.

Issues faced in valuation

The central idea underlying this method is the estimation of hypothetical costs saved or expenses avoided due to ownership of the customer related intangible asset. Such implicit assumptions are not directly observable in the projections provided by the management.

➢ **Distributor method**

Another method under the income approach is the distributor method. The process under the distributor method is strikingly similar to the MPEEM approach with the key difference being that contributory charges on only those assets are reduced which would be required in a distribution function.

Entities which have customer relationships mirroring the relationships distributors share with their customers may use the distributor method for valuation of their customer relationships subject to availability of market distributor data.

- **COST APPROACH**

➢ **Replacement cost method**

The basic assumption of the cost approach is that a prudent investor would not pay for an asset an amount more than for which the utility of the asset can be replaced. The cost approach uses replacement cost as an indicator of fair value. Following is an illustrated layout of the replacement cost method of valuing customer related intangibles:

PARTICULARS	AMOUNT
Cost per new customer (A)	xx
Number of new customers on acquisition date (B)	xx
Selling and marketing cost for existing customers (C = A x B)	xx
Opportunity cost (D) (% return on customer related intangibles * C * Years to recreate customer related intangible)	xx
Entrepreneur's profit (E) (EBIT, net of tax margin * C * Years to recreate customer related intangible)	xx
FAIR VALUE OF CUSTOMER RELATIONSHIPS (C + D + E)	XX

The components of the replacement cost approach are outlined as below:

- **Direct and indirect costs** should be inclusive of all costs associated with recreating the customer base at the valuation date. In a broader sense, these include the selling and marketing expenses incurred by the entity. Examples may include sales staff time, marketing expenses, customer entertainment, advertising campaign costs, public relations expenses, broad media campaigns, and general printing costs.

- **Opportunity costs** reflect the profit foregone on the amount invested (including the developer's profit) during the time required to create the intangible asset. When valuing customer related intangibles using the replacement cost method, a reasonable rate of return to calculate the opportunity costs must be estimated. If opportunity costs are significant, application of the cost approach may not be appropriate.

- In the context of valuation of customer related intangibles using the cost savings method, **developer's profit** pertains to market participant margins on the development activities of the company. An appropriate benchmark for these would be margins of value added resellers or distributors.

The replacement cost method is best suited when the customer related intangible asset can be replaced within a short period of time, opportunity costs are low, and the replacement costs can be easily estimated.

Issues faced in valuation

- **Estimating cost per new customer** – In order to estimate the cost per new customer, the subject company's historical selling and marketing costs for acquisition of customers is required. However, a company seldom has its expenses categorized in this manner. In such a situation, appraisers often have to make do with an appropriate proxy.

- The application of the cost approach to value customer related intangibles is often questionable because the assumptions required under this method such as developer's profit margins, time to recreate the intangibles, opportunity costs are not usually observable for the customer related intangible asset.

FAQS

- **How should overlapping customers between acquirer and acquiree be treated?**

  As most of the acquisitions take place in the same industry, existence of overlapping customers remains a strong possibility. Whether overlapping customers should be included in the valuation of customer related intangibles or not, should be evaluated on a market participant basis and not on an entity specific basis. If the overlapping customers would result in incremental cash flows to the acquirer, they may be considered in the valuation of the customer related intangible asset.

- **How should contributory charge on negative working capital be treated in the application of MPEEM?**

  Whenever an appraiser encounters an entity having negative working capital, it is crucial to see whether that phenomenon is entity specific or reflects the economic realities of the industry. In the case of the former, as fair value is based on market participant assumptions, the appraiser should base the calculations on industry working capital assumptions. However, if negative working capital is an industry-wise phenomenon, a negative charge on working capital may be applied.

- **How to determine the useful life of non-contractual customer related intangible assets?**

  ASC 350: Intangibles: Goodwill and Other, define useful life of an intangible asset, "the period over which the asset is expected to contribute directly or indirectly to the cash flows of the entity." Certain best practices for assessing the useful life of non-contractual customer related intangibles are:

  - Extending the cash flows until the marginal contribution of the last discrete cash flow does not materially change the value. Materiality is often quantified in percentages and should be based on discussions with management.

  - The subject entity's experience in renewing or extending the customer relationships may be assessed. In the absence of such historical data, market participant assumptions regarding the same should be considered.

The intangible value component of businesses has been overshadowing the tangible value component in the recent decades. With the exponential growth of the tertiary sector globally, the importance of such intangible component, especially technology and customer relationships, has been on the rise. With customer relationships driving a significant portion of a business' value, it is essential to value them appropriately using the appropriate methods and reliable input estimates.

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