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PENINSULA PALO ALTO CHAPTER OF INSTITUTE OF
MANAGEMENT ACCOUNTANTS

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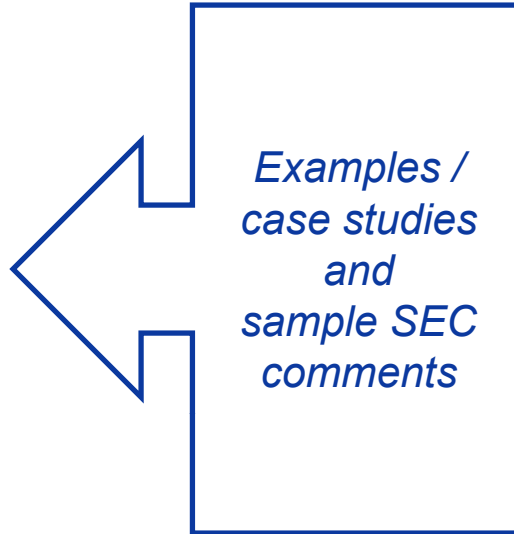


**BUSINESS COMBINATIONS &
PURCHASE PRICE ALLOCATIONS**

DAY 2 - AUGUST 18, 2012

AGENDA – BUSINESS COMBINATIONS & PURCHASE PRICE ALLOCATIONS

- **Introduction**
- **Basic Background & Reference Slides**
- **Auditor Review Considerations**
- **Recent Issues**
 - Market participant assumptions
 - Earn-outs / contingent consideration
 - Asset-specific assumptions
 - Amortization life estimates and methods
 - Other
- **Q&A**
- **Appendices**
 - Valuation methodology overview
 - Presenter biography / contact information



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**BASIC BACKGROUND &
REFERENCE SLIDES**

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Basic Background & Reference Slides

Overview of Purchase Price Allocation Principles

■ Standards References

- ASC 805, *Business Combinations* (formerly SFAS 141R)
- ASC 820, *Fair Value Measurements and Disclosures* (formerly SFAS 157)

■ Incorporation of fair value concepts in ASC 820 has lead to changes in “traditional” purchase price allocation considerations and unique issues

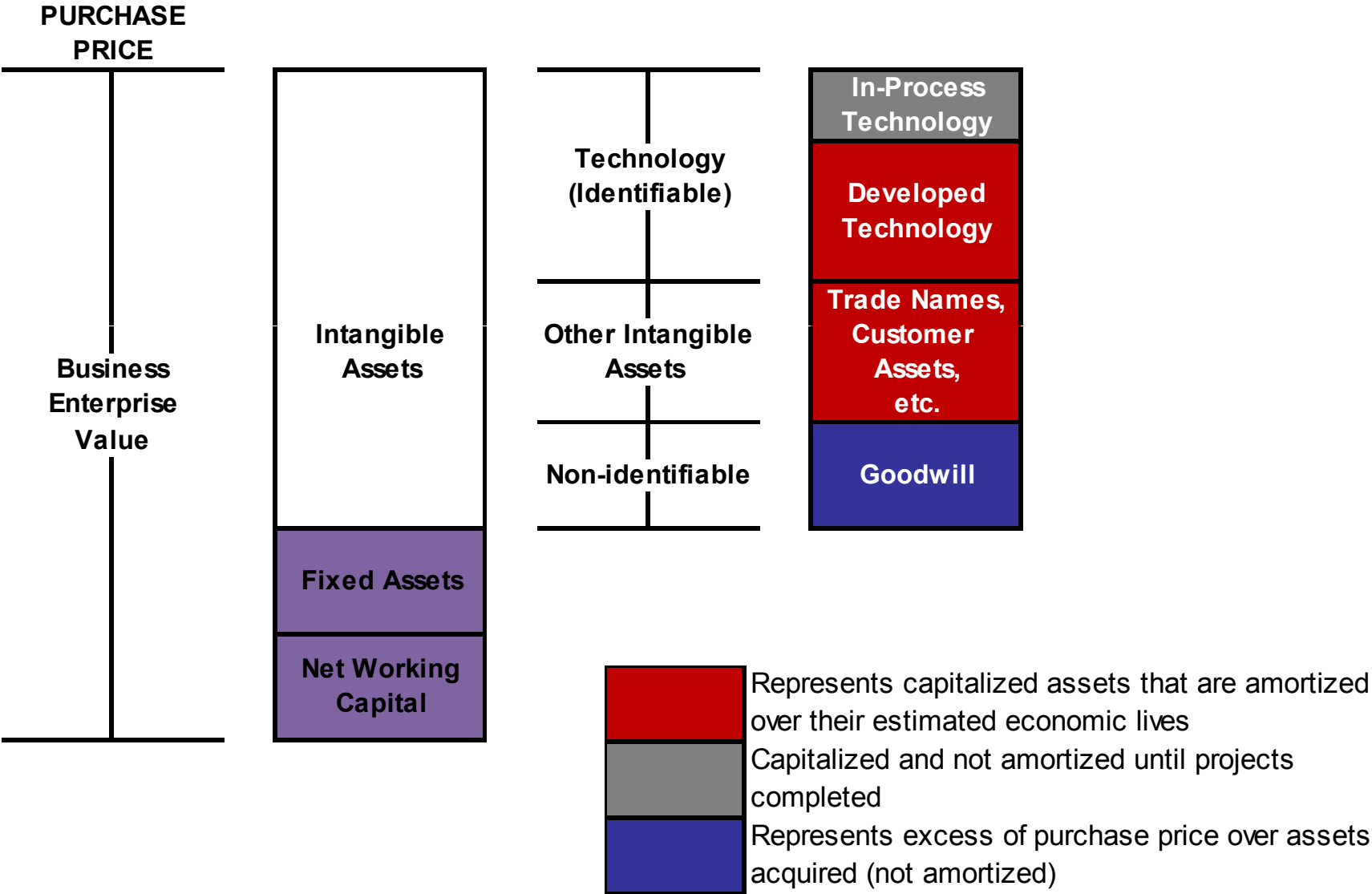
- Market participant standard (discussed on pp. 18-20)

■ Other Published Guidance

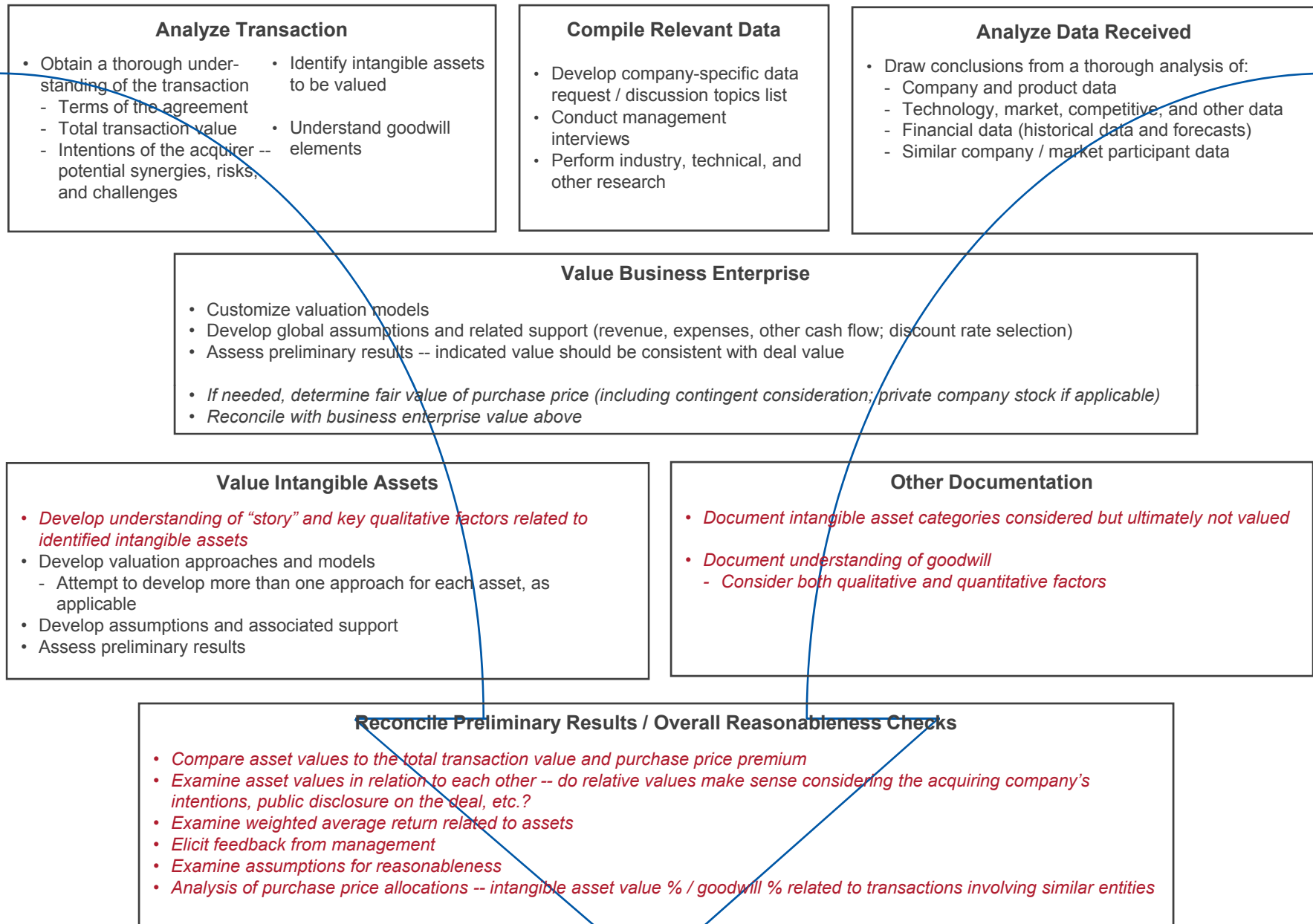
- Appraisal Foundation Monographs
 - *Identification of Contributory Assets and Calculation of Economic Rents* (issued 2010)
 - *Valuation of Customer-Related Assets* (draft issued in 6/12)
- AICPA IPR&D Practice Aid (draft issued in 11/11)

Basic Background & Reference Slides

Overview of Purchase Price Allocation Principles (cont.)



Flowchart of a Typical ASC 805 Valuation Engagement -- Intangible Assets



Work with audit team as needed

Basic Background & Reference Slides

Overview of Purchase Price Allocation Principles (cont.)

Business Enterprise Model

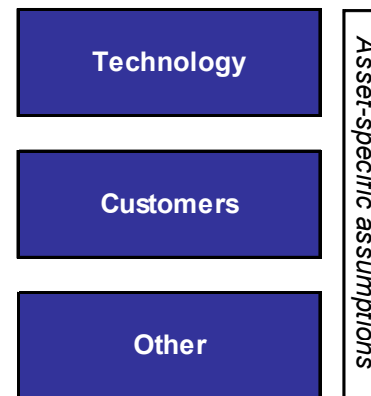


Enterprise Value -
Ties to
purchase price

Purchase Price

Upfront payment + fair value of
of non-cash
consideration +
earn-outs / contingent
payments

Intangible Asset Models



Assumptions
feed into
intangible
asset models

*Incorporate understanding of "THE STORY"
behind company / assets*

Basic Background & Reference Slides

Overview of Purchase Price Allocation Principles (cont.)

Typically Recognized Intangible Assets

<p>Technology-Based Intangible Assets</p> <ul style="list-style-type: none"> - Patented Technology - Unpatented Technology - In-Process Research and Development - Databases <p style="margin-left: 150px;">} <i>Developed Technology</i></p>	<p>Customer-Related Intangible Assets</p> <ul style="list-style-type: none"> - Backlog - Customer Contracts - Customer Relationships (Non-Contractual) - Customer Lists
<p>Marketing-Related Intangible Assets</p> <ul style="list-style-type: none"> - Trademarks, Trade Names - Trade Dress (Unique Color, Shape, Package Design) - Internet Domain Names - Non-Competition Agreements 	<p>Contract-Based Intangible Assets</p> <ul style="list-style-type: none"> - Licensing, Royalty Agreements - Franchise Agreements - Operating and Broadcast Rights

Artistic-Related Intangible Assets

- Pictures, Photographs
- Video and Audiovisual Material (Motion Pictures, TV Programs)
- Musical Works (Compositions, Song Lyrics)

Basic Background & Reference Slides

Qualitative Factors and Impact on Intangible Asset Values

Factors and Considerations	Impact of Factor on Identified Intangible Assets ("IIA") or Goodwill		Notes
<u>General Business and Deal Factors</u>			
- Long company history	↑ IIA	↓ Goodwill	
- High profitability in recent historical periods	↑ IIA	↓ Goodwill	
- High revenue growth and profitability projected in the next several years	↑ IIA	↓ Goodwill	Both aspects add more value to identified intangible assets since these increase economics in early years when present value factors are higher.
- Higher deal multiples paid for the acquired business	↓ IIA	↑ Goodwill	Likely translates into more value in the terminal period (which does not impact the intangible asset valuation models).
- Acquirer plans to make significant changes to the acquired business as part of its integration plans	↓ IIA	↑ Goodwill	Assumes acquirer plans would be similar to market participant likely plans
- Acquirer rationale for the acquisition (e.g., detailed in the deal press release) explicitly references identified intangible assets (like customers or technology)	↑ IIA	↓ Goodwill	

Basic Background & Reference Slides

Qualitative Factors and Impact on Intangible Asset Values (cont.)

Factors and Considerations	Impact of Factor on Identified Intangible Assets ("IIA") or Goodwill		Notes
<u>Intangible Asset-Specific Considerations</u>			
<i>Contracts / Customers</i>			
- Significant / material long-term contracts and backlog acquired	↑ IIA	↓ Goodwill	
- High customer retention / contract renewal anticipated	↑ IIA	↓ Goodwill	
- Ability and high expectations to sign new contracts / sell additional products to current customers	↑ IIA	↓ Goodwill	
<i>Developed Technology</i>			
- Significant changes to products expected over the next several years	↓ IIA	↑ Goodwill	
- Company spends significant R&D on new development (vs. maintenance)	↓ IIA	↑ Goodwill	
- Long product / technology lifecycle anticipated	↑ IIA	↓ Goodwill	
- Company has significant patents which are key to its business	↑ IIA	↓ Goodwill	
- Few alternatives exist to the company's technology	↑ IIA	↓ Goodwill	

Basic Background & Reference Slides

Qualitative Factors and Impact on Intangible Asset Values (cont.)

Factors and Considerations	Impact of Factor on Identified Intangible Assets ("IIA") or Goodwill	Notes
<u>Intangible Asset-Specific Considerations (continued)</u>		
<i>Trade Names</i>		
- Business / product trade names are expected to be retained after the acquisition	↑ IIA ↓ Goodwill	
- Strong strength of the trade names in the market / high customer recognition	↑ IIA ↓ Goodwill	
- Trade names attract customers and offer strong pricing or other advantages	↑ IIA ↓ Goodwill	

Basic Background & Reference Slides

Qualitative Factors and Impact on Intangible Asset Values (cont.)

Comparison of Intangible Assets by Industry

Intangible Asset	Software Company	Services Company	Telecom Service Provider
Technology	High	Low / None	Low / None
Customer Assets	Depends (Low to High)	High	Low / Medium
Trade Name, Trademarks	Low	Depends (Low to High)	Depends (Usually Low)
Licenses	NA	NA	High

- ☞ *Examples*
#1 *Government services company*
#2 *Wireline services company*
#3 *Winery*

Basic Background & Reference Slides

Goodwill Analysis

- Goodwill represents total purchase price less identifiable assets (tangible and intangible)
 - A detailed understanding and explanation of goodwill is key – not just what’s leftover
 - Especially if goodwill is a large portion of the purchase price premium
 - Consider both qualitative and quantitative factors
 - Synergies with acquirer -- cost, revenue, other
 - Market presence
 - Market “window of opportunity”
 - Value attributable to future, yet-to-be-defined technology and future customers
 - Assembled work force value
- ☑ *Sample SEC comment: “Disclose factors that resulted in recognition of goodwill and explain why a large premium was paid for the acquisition.”*

AUDITOR REVIEW CONSIDERATIONS

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Auditor Review Considerations

Collaboration and consensus among **management, auditors** (both audit and valuation teams), and **external valuation specialists** is key

- Key when acquisition has unusual or atypical considerations; recommended when purchase price includes contingent consideration
- Audit team questions (“tie-out” / PBC) and Valuation team questions (theory, methodologies, and valuation-specific assumptions)
- Firm and reviewer-specific considerations and preferences
- Consensus between local audit team vs. “National” standards group
- Well reasoned approaches + high quality documentation needed

Engage in planning discussions as early as possible

*Example #4
Marketing services company*

RECENT ISSUES



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Recent Issues

Market Participant Assumptions

■ ASC 820 Definitions

- “Price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between **market participants** at the measurement date.”
- Occurs in the **principal or most advantageous market** from the seller’s perspective; *highest and best use*
- Market participants are:
 - Independent of the reporting entity
 - Knowledgeable
 - Able to transact
 - Willing to transact (motivated; not forced)
- Reporting entity does not need to identify specific market participants; it should identify characteristics that distinguish market participants generally
- Both strategic and financial market participant buyers should be considered

Recent Issues

Market Participant Assumptions (cont.)

- Not necessarily the value specific to the reporting entity
 - Include market participant synergies; exclude entity-specific synergies only available to a specific buyer
 - Discount rate considerations – market participant borrowing costs, capital structure, and tax impact

☑ *Sample SEC comments:*

- *“Please tell us how you determined the discount rate used in your fair value measurements and how you were able to conclude that assumption is what market participants would use”*
- *“Tell us why you utilize your own weighted average cost of capital rather than that of a market participant when determining your discount rates”*

- ☞ *Examples*
 - #5 Government services company – acquisition by prime contractor of sole subcontractor*
 - #6 Wireless services company – definition of market participants in Greenfield analysis of spectrum licenses*

Recent Issues

Market Participant Assumptions (cont.)

- **Assets That Acquirer Does Not Intend to Use**

- ASC 805 requires all assets to be measured at fair value from a market participant's perspective – without regard to acquirer intent

- **Defensive Asset**

- Asset which an acquirer does not intend to actively use but intends to prevent others from using it
- Asset is likely contributing to an increase in the cash flows of other assets owned by the acquirer
- Acquirer should use market participant, not acquirer-specific assumptions

- ☞ *Examples* #7 *Mobile software company (valuation of defensive technology asset)*
 #2 *Wireline services company (transition value only of trade name)*

Recent Issues

Earn-Outs / Contingent Consideration

- **Additional payments based on future events or conditions**
- Could be based on future revenue, earnings, R&D milestones, regulatory approvals, etc.
- Under ASC 805, contingent consideration is **recognized at acquisition-date fair value as part of the consideration transferred** (purchase price calculation)
- Trends related to earn-out structures**
 - Use of earn-outs increased from 19% of public company acquisitions of private targets in 2006 to 29% in 2008 and 38% in 2010 (ABA study)
 - 60% of transactions in D&P study had earn-outs tied to top line metrics (revenue, bookings, units sold, gross profit, or assets under management)
 - In D&P study, on average one year later the future had unfolded roughly according to expectations
- Earn-out challenges ➤ *Example #8 Cloud technology company*
- **Valuation Considerations**
 - Analytical framework: Scenarios and probabilities; real options
 - Discount rate – various types of risk to consider

** Statistics as summarized in *Valuation Insights* (Third Quarter 2012), Duff and Phelps (“D&P”); relates to: (i) American Bar Association (“ABA”) Business Law Section 2011 Private Target Mergers & Acquisition Deal Points Study; (ii) D&P Contingent Consideration Study involving 120 transactions that included an earn-out between 2009 and 2011.

Recent Issues

Earn-Outs / Contingent Consideration (cont.)

☑ *Sample SEC Comment: “In light of the materiality of contingent consideration paid to date on previous acquisitions, please include a detailed discussion of all contingent consideration arrangements currently in effect, including the methodology used to determine the amount and timing of future payments and amounts paid during the periods presented under each arrangement”*

☞ *Example #9 SaaS marketing company (revenue-based earn-out)*

Recent Issues

Asset-Specific Assumptions

- **Acquisitions with Both Technology and Customer Assets**

- Evolving selection of preferred methodologies to avoid cross contributory asset charges (Excess Earnings Method, p.31)**
- Methodology selection depends on “primary” asset

- **Customer Relationships**

- Distributor Method
 - Relatively new method (detailed in Appraisal Foundation *Customer-Related Assets* Monograph, 6/12)
 - May be appropriate when relationship between an entity and its customers is similar to that of a distribution company and its customers
 - Incorporates guideline company distributor margins
- Acquisitions with multiple types of customer assets -- deferred revenue, backlog, and customer relationship

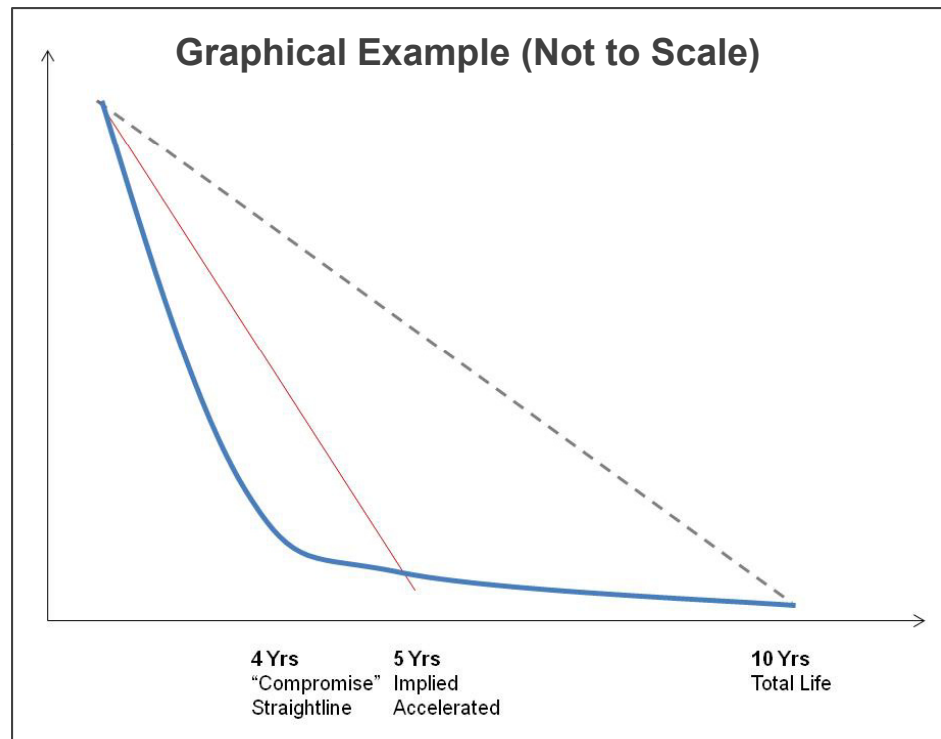
** See Appendix for further details on valuation methodologies

Recent Issues

Amortization Life Estimates and Methods

- Useful life and amortization method (straight line vs. accelerated)
- Accelerated amortization often seen with subscriber base assets in the telecommunications industry

☞ *Example #10 Various wireline and wireless services acquisitions*



- Support and implications for indefinite-life assumption

Recent Issues

Other

- Bargain purchases (rare; will draw scrutiny)
 - Whether an acquisition meets the definition of a business (ASC 805-10-20); broader definitions
 - Plan ahead for future impairment testing
 - Consider how goodwill might be allocated to potential reporting units and assess drivers of goodwill impairment
- ☑ *Other SEC comments*
- *Disclosures need include all information required by ASC 805-10-50, 20-50, and 30-50*

QUESTIONS?

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APPENDICES



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Valuation Methodology Overview

- Three traditional valuation methods for any asset

- *Cost Approach*
- *Market Approach*
- *Income Approach*

- Cost Approach

- What would it cost to recreate the intangible and its present market position?
- Rarely applicable – cost does not equal value
 - Millions were spent by RJR on developing a smokeless cigarette or by Coca Cola on the development and marketing of “New Coke.”
- Considered for intangible assets and embryonic technology where market potential exists but is impossible to estimate at the early stage
- Often used as a “reasonableness check” for certain intangible assets
 - Customer assets (cost to replace based on necessary sales and marketing resources)
 - Technology (cost multiples)

Valuation Methodology Overview (cont.)

■ Market Approach

- Comparison of subject property to recently priced property (sale, license, transactions, etc.) that is similar and for which price information is available
- Characteristics of ideal transaction:
 - Transaction should be between unrelated parties
 - Neither party compelled to complete transaction
 - Involves similar property for use in the same industry as the subject property
 - Relevant date of transaction
- Market transactions or identifiable comps are rare for individual intangible assets
 - Few transactions of similar property
 - Financial details often not disclosed

Valuation Methodology Overview (cont.)

■ Income Approach

- *Present value of future economic benefits*

- *Project net cash flows*
- *Determine appropriate discount rate*

- **Relief from Royalty Method**

- If we did not own the asset, how much would we pay to license it?
- Estimates a projected stream of hypothetical royalty income generated from the licensing of the subject intangible asset to determine fair value:
 - Estimate royalty base -- revenue from products which incorporate the asset
 - Determine appropriate royalty rate
 - Key factors:
 - What are comparable intangibles being licensed for?
 - What is the remaining economic life?
 - What are the relative strengths of the intangibles?
 - Consideration of market potential and competing assets
 - Determine appropriate discount rate
 - Estimate present value of after-tax royalty savings

Valuation Methodology Overview (cont.)

- **Income Approach**

- **Excess Earnings Method**

- Considering all assets used in the business, what economic return is attributable to the subject intangible asset?

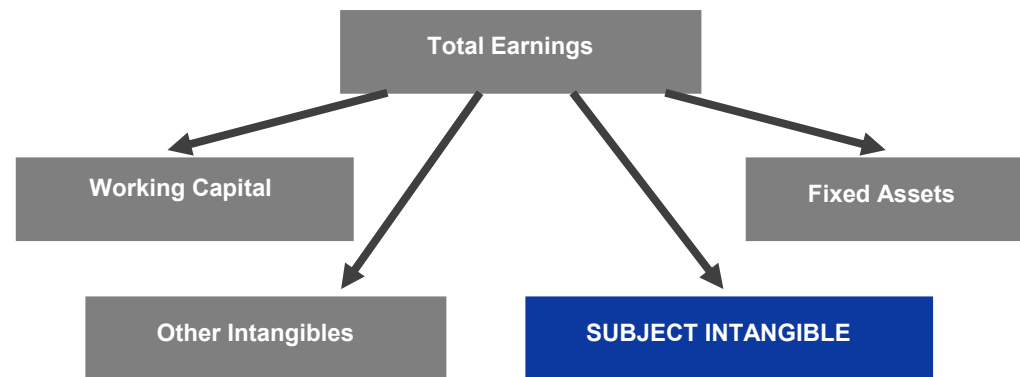
Total earnings for business

Less returns to:

Working capital
Fixed assets
Intangible assets

Equals:

Excess earnings
(calculate present value)



Valuation Methodology Overview (cont.)

- **Income Approach**

- **Lost Profits / With and Without Method**

- The value of an intangible asset is calculated by taking the difference between the business value estimated under two sets of cash flow projections:
 - The value of the business with all assets in-place at the valuation date.
 - The value of the business with all assets in-place *except the subject intangible asset* at the valuation date.

- **Greenfield Method**

- A subject intangible asset is valued using a hypothetical cash flow scenario of developing an operating business in an entity, that at inception only holds the subject intangible asset. Consequently, this valuation method is most relevant for assets that are considered to be scarce or fundamental for the business, even if they do not necessarily drive the excess returns that may be generated by the overall business.
- Frequently used to value broadcasting licenses.

Speaker Background / Contact Information

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Current Responsibilities

Josette Ferrer is the founder and a Managing Director of Clairerent Advisors. Since 1993, Josette has been assisting clients with the valuation intangible assets, intellectual property, stock options, of closely held businesses and business interests, debt instruments, capital equipment / fixed assets, and other assets.

Experience

Prior to founding Clairerent Advisors in 2010, Josette was the U.S. Practice Leader of Marsh's Valuation Services Group (formerly Kroll's Valuation Services Practice). Her career includes serving as the Managing Director in charge of the San Francisco Valuation Services Group of WTAS, Inc. ("WTAS"), a former subsidiary of HSBC Group. At WTAS, Josette's responsibilities included developing and overseeing all technical, operational, marketing functions for the SF valuation team. Prior to WTAS, Josette was a director with Huron Consulting Group and a senior manager at Arthur Andersen LLP.

While Josette has extensive experience serving clients in many industries, areas of specialty include high technology, early stage ventures, telecommunications, service companies, consumer products, manufacturing, and financial services companies. Her clients have ranged from small, emerging businesses to Fortune 500 companies. Josette has been a guest speaker for a wide variety of forums, including Financial Executives International ("FEI"), the Institute of Management Accountants ("IMA"), the Practising Law Institute ("PLI"), the San Francisco Bar Association, Santa Clara University, BIOCOM, and various venture capital roundtables, and has also published an article related to the valuation of intellectual property for the PLI.

Education and Affiliations

- B.S. in Business Administration, University of California, Berkeley
- Member, Fair Value Forum
- Board Member, SF chapter, Financial Executives International
- American Society of Appraisers
- ProVisors