Valuation & Litigation Briefing

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FAQs about valuing customer relationships

For many businesses, customer relationships represent a valuable intangible asset. But placing a monetary value on those relationships can be tricky. Here are answers to common questions about the considerations, techniques and challenges involved in valuing customer-related assets.

Why value customer relationships?

The most common reason to value customer relationships is compliance with business combination accounting standards under U.S. Generally Accepted Accounting Principles (GAAP). These rules require an acquirer to recognize and determine the fair value of identifiable acquired assets, including customer relationships and other customer-related assets. These assets may also need to be valued for various tax and litigation purposes.

Do all customer relationships have value?

The value of customer relationships is generally derived from the expectation of repeat business. Often, this value is based on contractual agreements. But even without contracts, a business may leverage information contained in customer lists — including contact information, financial information, purchase history and preferences — to make future sales to existing customers.

However, not all customer interactions produce an expectation of repeat business. For example, contacts with walk-up retail customers are generally viewed as insufficient to support such an expectation.

When valuing customer relationships, financial experts typically focus on the income approach, rather than the market or cost approaches.

It's also important to recognize that expected repeat business isn't always attributable to customer-related assets. Often, it can be traced to 1) the strength of a company's brands or trade names, or 2) a company's market dominance, which leaves consumers with few acceptable alternatives.

Which methods are used?

When valuing customer relationships, financial experts typically focus on the income approach, rather than the market or cost approaches. The market approach generally isn't feasible because there's limited transactional data available involving comparable assets. That's because customer lists are usually transferred as part of a business sale rather than a standalone asset. And the cost approach is rarely used, given the relatively long time needed to replace a customer-related asset.

The most common income-based method for valuing customer relationships is the multiperiod excess earnings method (MPEEM). This method measures economic benefits by 1) projecting cash flows attributable to customer-related assets existing on the valuation date, 2) deducting the portion of those cash flows attributable to "contributory assets," and 3) discounting those cash flows to present value using a risk-adjusted rate of return.

Alternative valuation methods

In addition to the multiperiod excess earnings method (MPEEM) discussed in the main article, experts can use several other accepted methods to value customer relationships. Examples of alternative methods include:

Distributor method. This is a variation of the MPEEM. It may be appropriate when the nature of the relationship between a company and its customers is similar to that of a distributor and its customers. For example, it may be used when intangibles — such as strong brands or unique, high-value technology — drive customer demand and customer-specific efforts are limited. This method assumes that returns on customer-related assets are comparable to the profits generated by a hypothetical distributor.

With-and-without method. This method estimates value under the assumption that all customer-related assets must be replaced. Revenues, operating expenses and cash flows are projected with customer-related assets and without those assets. The difference between the two scenarios is used to estimate the value of customer-related assets.

Cost savings method. This income-based approach directly measures the expected future benefit stream produced by an asset in terms of future after-tax costs that are avoided by owning the asset. This method may be appropriate when valuing an asset that lowers expenditures or improves efficiency.

Contributory assets are those that must be present for a company to generate value from customer-related assets. Examples include trademarks, trade names, technology, equipment and machinery, land and buildings, assembled workforce, and working capital.

How long do customer relationships last?

Because customer relationships are a wasting asset, estimating future cash flows requires the expert to forecast expected attrition. The most straightforward method is to apply a constant attrition rate. This is done by analyzing historical customer purchase information, calculating an attrition rate for each period for which data is available and developing a single, constant rate for use throughout the forecast period.

If sufficient data is available, an expert may apply different attrition rates based on customer size or other attributes to develop a more accurate forecast. For example, a bank may experience higher attrition rates for customers with smaller account balances than for those with larger balances.

Actuarial attrition analysis offers a more sophisticated approach in appropriate cases. Here, the expert measures the impact of the age of a customer relationship on attrition. For example, the expert may perform regression analysis to find a statistically significant linear relationship between age and attrition. Developing meaningful correlations between customer ages and attrition rates requires a significant amount of historical purchase data, however.

Assumptions are critical

A valuation of customer relationships is only as reliable as the assumptions on which it's based. Keep in mind that even small variations in projected cash flows, attrition rates and other inputs can have a big impact on value. So, give your valuation expert sufficient historical data to help ensure reliable results. ■

Lightbox Ventures, LLC v. 3rd Home Limited

Expert reports excluded due to unsupported assumptions

It can be risky for experts to unquestioningly rely on data and assumptions from clients when computing lost profits or valuing a business. In this case, a federal district court excluded expert testimony on *Daubert* grounds, because numerous unsupported assumptions rendered the reports "useless."

Nothing ventured …

The litigants were joint venture partners: Lightbox (an online real estate firm specializing in luxury vacation homes) and 3rd Home (a luxury home exchange program). Through the joint venture, Lightbox would earn brokerage commissions and other fees from vacation home sales by 3rd Home customers.

> *The court found that the wide range of potential valuations and disclaimers that accompanied the valuation analyses undermined their value.*

The joint venture agreement required 3rd Home to 1) maintain an active link on its website to the joint venture website, 2) forward all inquiries regarding property sales to Lightbox, and 3) refrain from entering into any "similar" arrangements with other brokerage firms.

Lightbox filed a lawsuit, alleging that 3rd Home breached the agreement and its fiduciary duties. Among other things, the defendant allegedly failed to activate the link to the joint venture's website and entered into competing arrangements with other brokers.

Blind acceptance

Lightbox engaged two experts to compute lost profits and value the joint venture. However, the U.S. District Court for the Southern District of New York determined that neither expert met the *Daubert* standards for admissibility and excluded both opinions. Why? They had accepted assumptions and data supplied by the plaintiff without independent verification, including:

- "Optimistic" revenue and growth projections,
- The number of 3rd Home members,
- The value of listings on the website,
- The percentage of potential sale listings the joint venture would win,
- Average sales prices and costs, and
- The unsupported assumption that the sale of a listed property would entitle the joint venture to a commission.

In addition, the court found that the wide range of potential valuations and disclaimers that accompanied the valuation analyses undermined their value. For example, one expert warned that, because the business had "barely any track record," projections were "highly dependent upon the assumptions and inputs used." The plaintiff's projected values ranged from $372,000 to more than $31 million, and the expert disclaimed "any opinion as to whether the business could actually be sold."

The court said that, without a basis for finding the listings and projections reliable, any valuations based on that data must be stricken. Even though the expert had conducted extensive analysis, "its valuation is ultimately a projection built on sand."

Build a solid foundation

While experts often rely on information provided by clients and attorneys, they must consider whether assumptions appear reasonable and market data is relevant. Experienced experts apply professional skepticism when analyzing financial data and arriving at conclusions about lost profits and business value. ■

What's in a name?

Quantifying damages for reputational harm

Remember the drug tampering incident involving Tylenol products in the 1980s or allegations of accounting malpractice against Arthur Andersen following the Enron scandal? Negative events — including defamation, securities fraud, product liability, intellectual property (IP) infringement, and data breach and other cybercrime proceedings — can seriously impair a company's reputation.

Some damages are permanent; others are only temporary. Measuring the financial impact of reputational harm can be challenging. But these calculations may be necessary to quantify damages in a litigation context or to support an insurance claim.

Measurement tools

Reputational harm can manifest itself in several ways. Examples include lost profits, depressed stock prices, lost enterprise value, and impaired value of trademarks, tradenames and other IP assets. Whether a company may seek legal remedy from the wrongdoer for such harm depends on the nature of the case and applicable law.

Assuming damages are available, the following methods can be used to quantify losses:

Lost profits. A financial expert estimates a company's lost sales resulting from its damaged reputation, using one of several methods. Then he or she discounts them to present value.

For example, an expert might compare a company's postinjury sales to its preinjury sales (the "before-and-after" method) or to sales of comparable businesses or an unaffected segment of the company's business (the "yardstick" method). Under either method, the expert should account for any unrelated factors that have an impact on the company's sales, such as poor macroeconomic conditions or changes in technology.

Lost business value. The expert calculates damages based on impairment of a company's value, using one or more accepted valuation methods. Generally, this approach is appropriate when a reputational injury permanently destroys the business or a discrete segment of the business. If the injury is temporary — even if it takes years to recover — lost profits are typically used.

Relief-from-royalty method. This method is commonly used to value certain IP assets. It tends to be most appropriate if injury to a company's reputation impairs the value of a brand, trademark or tradename.

Essentially, the expert values the brand or other asset based on the royalty rate the company would have paid to license the asset if it didn't own it. To apply this method, the expert selects a royalty rate based on available market data for licenses involving similar companies and similar IP assets. Then he or she applies that rate to the company's projected revenues and discounts the royalty stream to present value.

Event studies. These studies are often used in securities litigation to measure the impact of an event — such as a disclosure that corrects a prior misrepresentation — on a public company's stock price. They can also be used to measure the effects of a reputation-harming event, such as a data breach or fraud allegations. The expert uses statistical methods, such as regression analysis, to isolate the portion of price drop that's attributable to the event from the portion that's attributable to other factors.

In some cases, a company may launch a public relations campaign to assuage the concerns of customers and investors. Depending on relevant laws, the injured party may be able to recover the cost of the PR campaign, along with other expenditures to mitigate reputational harm.

Here today, gone tomorrow

Reputational harm is one of the most significant risks companies face today. A single event can suddenly destroy a reputation that took years or even decades for a company to build. Fortunately, with the help of experienced financial experts, there are methods available to quantify — and recover — reputational damages.

What are the three levels of value?

How much control does a business owner have? And how readily can the business interest be converted to cash? Those are the main questions that need to be addressed when determining the level of value in a business valuation. That level may affect your expert's analyses and techniques. So, it's important to get it right as soon as you hire an expert. Here's an overview of the three main levels of fair market value.

1. Value of a controlling interest

Control value is the first level. The ability to control a business's decisions has impact on value, especially on the value of a private firm. So, potential buyers often may be willing to pay more for a controlling interest than for a minority interest. The key to arriving at a control value is to make discretionary adjustments to the company's cash flow, such as adjusting for above- (or below-) market-related party transactions or owners' compensation.

Control value can be broken down further into 1) strategic and financial control value or 2) public and private control value. But appraisers don't always agree on these classifications. The difference between strategic and financial control is the expected synergies available to a strategic buyer. Strategic buyers often pay a premium over financial buyers, if they possess synergies that may not be available to other buyers.

Public and private merger-and-acquisition (M&A) methods generate cash-equivalent control values. Some business valuation experts contend that controlling interests take time and resources to sell and, therefore, may warrant an illiquidity discount — regardless of whether they're based on public or private transactions. No empirical studies exist, however, that directly quantify illiquidity discounts.

2. Value on a minority, marketable basis

Minority shareholders who can't control day-to-day business operations sometimes are unwilling to pay as much per share as controlling shareholders. Rather than take a discrete discount for lack of control, valuation experts typically arrive at a minority level of value by abstaining from making discretionary adjustments to cash flow.

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Because public companies' professional management teams usually want to maximize earnings per share, their financial statements may require few or no discretionary adjustments. Assuming controlling shareholders don't abuse their discretion (as may be the case with a public company), the pro rata share of a public company's value on a controlling basis closely approximates the value of shares on a minority, marketable basis. In other words, there's little to no discount for lack of control in these cases.

Conversely, marketability refers to how quickly and easily shares can be converted to cash. Shares of Apple or Johnson & Johnson are sold on the New York Stock Exchange and can be bought or sold

simply by calling an investment advisor, for example. Marketability is worth something to investors. Both the guideline public company method and the income approach can generate a marketable value, because they're based on public stock data.

3. Value on a minority, nonmarketable basis

Many business valuation assignments call for the value of a minority interest in a private company. This is generally the least valuable of the levels and is difficult to estimate directly, except by using previous arm's-length transactions of the subject company's stock. But previous transactions may not exist — or, if they do, they may not be relevant.

The typical starting point for this level of value is a minority, marketable value, as described previously. From there, a marketability discount is taken. Sources of empirical data for marketability discounts include restricted stock and initial public offering (IPO) studies.

Consult with a valuation expert

Take the guesswork out of determining the appropriate level of value or converting a preliminary value to the appropriate level of value. A business valuation professional knows how to quantify valuation discounts and adjust earnings using objective market data that can withstand scrutiny from the IRS, opposing counsel, judges and juries. ■

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- Fraudulent Actions
- Criminal Tax Matters
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