Hard to value: Customer relationships

Valuing a target company's customer relationships is never straightforward. PJ Patel and Ed Hamilton of Valuation Research Corporation explain a less common, but at times more useful, approach to the task.

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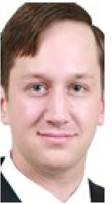
Since the advent of SFAS 142 and its ensuing guidance ASC805 the value of customer relationships has been a difficult issue to address. Over time and under the influence of US accounting standards and SEC guidance, best practices have evolved yet remain inconclusive in their applicability to all situations.

In addition, companies are sometimes surprised by the magnitude of the value allocated to customer relationships relative to the other assets acquired in a business combination.While historically the value of customer relationships and by extension asset amortisation has been more of an issue for publicly traded companies, it also has relevance for private equity firms as they consider exit strategies, including an IPO. The initial valuation of the customer relationship asset at acquisition can have a meaningful impact upon the earnings, EPS and P/E ratio.


Ed Hamilton

In valuing customer relationships, valuation professionals have historically relied on the application of traditional valuation methods and at times have failed to consider whether the value conclusion was consistent with a market participant's view. In many industries, customer relationships are not the most important asset, but traditional valuation methods tend to reflect customer relationships as a primary asset. A point that is often overlooked is that customers often purchase products or services because of the presence of intellectual property - the brand, or the technology - not the presence of a relationship.

In light of the inconsistency between the qualitative attributes of the customer relationships, and the value derived with traditional valuation techniques, we researched and analysed fundamental data (earnings, margins, working capital levels, fixed assets levels, etc.) and observed differences in margins, working capital levels and fixed asset levels between companies involved in manufacturing, sales and marketing, and ownership of intellectual property. For example, in the consumer products space, we observed that while some companies sold direct to retailers, others sold only through distributors and most sold product through multiple channels (i.e. both direct and through distributors). We observed that the margins for distributors in this space were extremely low, thus supporting a qualitative assessment that customers in this space were of nominal value and that mechanical application of traditional valuation methods may lead to the customer relationship value being overstated. This led to the development of the distributor method (DM) to value customer relationships. The DM will be part of a soon-to-be-released industry practice aid on the valuation of customer-related assets.

DISTRIBUTOR METHOD

The DM uses market observations of both wholesale and distributor operations for inputs when valuing customer relationships. It is assumed that the relationships held by a distributor with its customers are similar to those held by a company whose primary asset is something other than customer relationships (i.e. brands, technology, capital assets). Distributors and the company being acquired (target company) have the same key driver, the ability to provide the desired product or service in a timely manner. As such, distributor inputs are a reasonable proxy when valuing the relationships of the target company.

Consider two companies selling their products via a retailer. One has a low value brand and earns an eight percent profit margin. The other has a dominant brand and earns a 20 percent profit margin. What drives the difference? Are the relationships more valuable? More likely, the second product earns a higher margin largely due to the strength of the brand.

The DM can also be used outside of the consumer products space where appropriate market based evidence can be found as a proxy for inputs used in valuing customer relationships.

The DM is beneficial in situations where traditional valuation methodologies over estimate the value of customer relationships. This is especially true when traditional methodologies are applied mechanically. In applying the DM, the goal is to arrive at a value conclusion for the customer relationship that is consistent with a market participant's (and often management's) viewpoint.

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