RIVERON
PREPARE FOR CHANGE

ASK THE EXPERTS WEBINAR

Demystifying Fair Value

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KEY REMINDERS

- Riveron webcasts – past and upcoming
- 4 polling questions must be answered to obtain CPE
- If you have questions, feel free to ask in Q&A option in Zoom
- Webinar evaluation form & CPE certificate will be emailed to you
- On demand video is not eligible for CPE
- You will receive a follow up email including:
  - Access to this webinar recording and deck
  - The ability to join our Webinars Mailing list to receive future invites
  - Presenter contact info

Polling Question # 1

When evaluating a target acquisition, how do you value a business?

A. Intuition approach
B. Income approach, or discounted cash flows
C. Comparable approach
D. Throw a dart approach

FAIR VALUE CONCEPTS

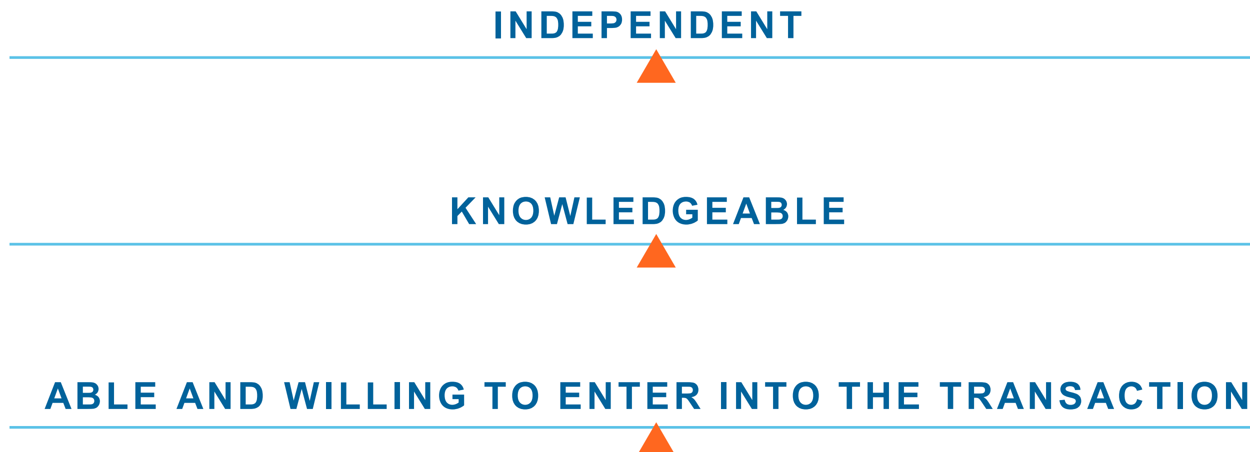
The Basics

WHAT IS FAIR VALUE?

ASC 820 defines Fair Value as:

The 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.

- Market based concept, not entity specific
- Assumes market participants are:



WHAT IS FAIR VALUE?

- The definition of fair value includes the following concepts:
  - Exit price - based on **current market conditions** on the measurement date, rather than a transaction that occurred at some earlier date
  - Assumes an **orderly transaction**, which infers a transaction where there is no undue pressure to sell, as may be the case in a corporate liquidation
- Differs from investment value, or company specific value
- Originally used in prohibition when breweries were shut down and had to be paid the Fair Value of the business

HOW DO YOU DETERMINE FAIR VALUE?

Fair Value can be determined using the following three methods

INCOME APPROACH

- Based on future economic benefits generated by a business or asset
- Most common application is the Discounted Cash Flow ("DCF") model
- Other forms of the income approach are used in valuing intangible assets

MARKET APPROACH

- Based on trading prices and transactions for identical or similar assets
- Comparison and correlation between subject entity and other similar entities

COST APPROACH

- Based on the concept of replacement or reproduction costs
- Premise is one would pay no more for an asset than the cost to reproduce or replace the asset
- More common in equipment valuation; less common in business valuations since it fails to capture goodwill; used as a "floor" value

INCOME APPROACH

Under the Income Approach, the most used technique is the Discounted Cash Flow (DCF) method. Two key steps:

1. Forecast future economic benefit (I.e., cash flows) the business is expected to generate

2. Discount the future benefits to present value at an appropriate discount rate

INVESTMENT RETURN	Various to a company standard hurdle rate or own company's cost of borrowing
WACC	Market participant derived weighted average cost of capital is used

MARKET APPROACH

TWO COMMON METHODS:

- Guideline public company method (GPCM): compares pricing metrics based on the stock prices of public companies to the subject asset
  - Two common metrics are Revenue and Earnings Before Interest, Taxes, Depreciation & Amortization (EBITDA). The multiples analyzed would be Enterprise Value / Revenue and Enterprise Value / EBITDA
  - These metrics are analyzed and compared to the metrics of the subject company

- Guideline company transaction method (GCTM): similar concepts but based on actual mergers and acquisitions of similar companies
- Key is identifying an appropriate peer group (industry, size, geography, etc.) and adjusting the multiples for differences between the comparable group and the subject company

EX:

Based on EBITDA multiples of comparable public companies, the median of 8x EBITDA is selected as the most appropriate multiple. EBITDA for the LTM period of the subject company is $10 million.

Enterprise Value: $10 million EBITDA x 8 = $80 million

Polling Question #2

Was financial due diligence conducted prior to your most recent business acquisition? If yes, by whom?

A. Yes, by management

B. Yes, by a third-party advisor

C. No financial due diligence performed

D. What is financial due diligence?

BUY SIDE DILIGENCE

Overview

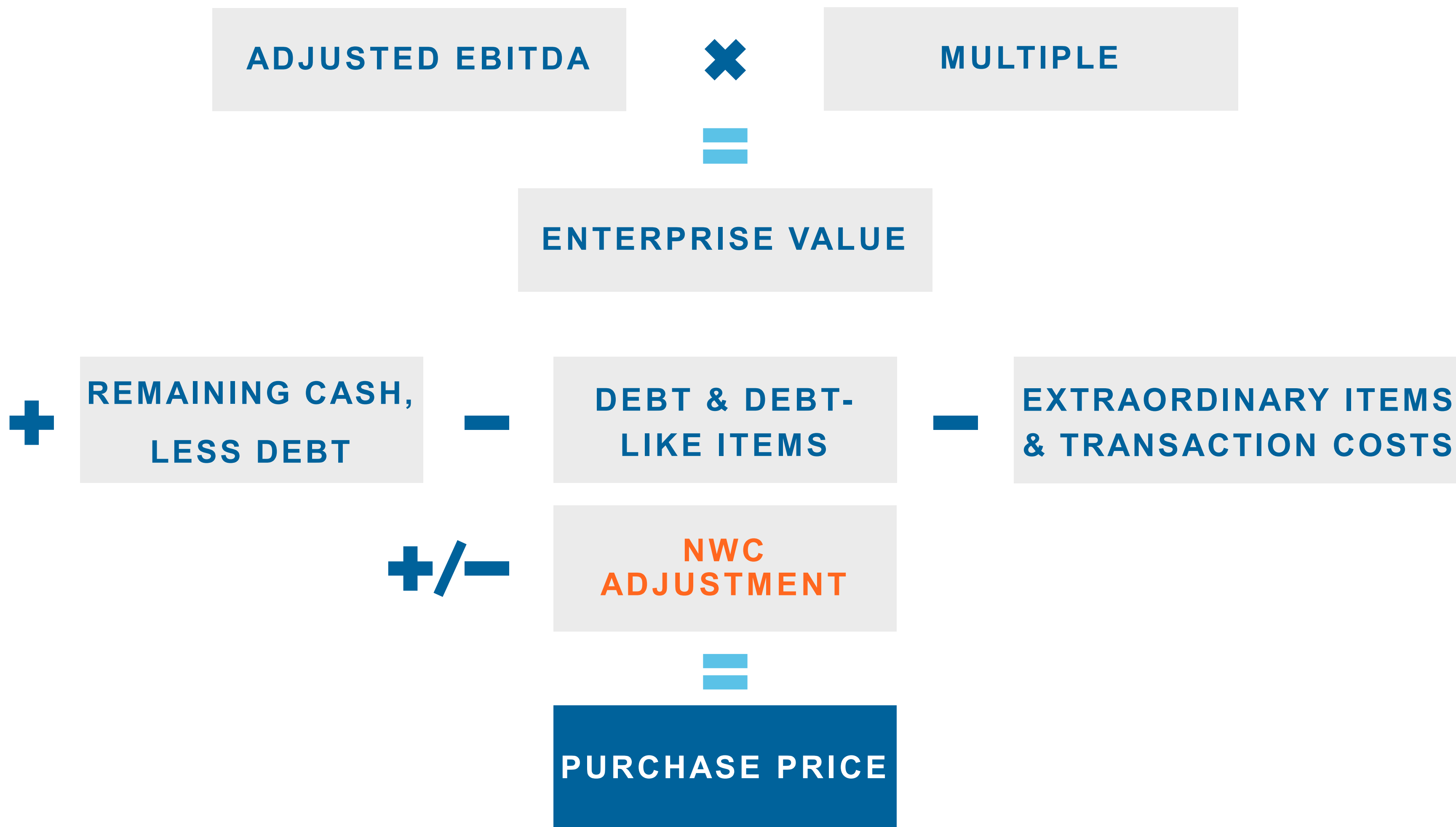
WHAT IS DUE DILIGENCE?

DUE DILIGENCE	FINANCIAL DUE DILIGENCE
Detailed investigation of a target company to identify risks, understand its performance and position, and validate its value.	Process of systematically examining detailed history of a company's operating results, and overall financial position. **Not a valuation of a company**. It is a process that **helps validate a given level of value** based on a deal metric. While financial due diligence focuses on the target company's historical performance and a normalized level of EBITDA, **results are often bridged to future EBITDA and performance expectations** in relation to key metrics of the deal. This helps validate forecasts and/or fair value levels that assume near term growth.

HOW DOES DUE DILIGENCE RELATE TO FAIR VALUE?

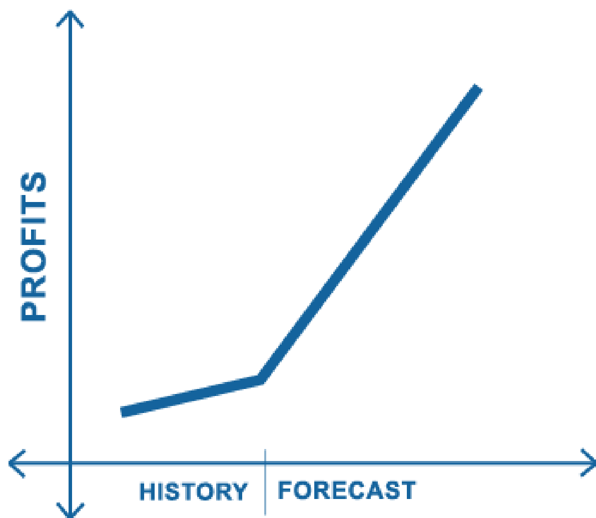
- The enterprise value of many target companies is often determined based on a multiple of EBITDA (or similar fair value measure as previously discussed) which is further adjusted for cash, debt, debt-like items and a normalized level of working capital - resulting in what is often referred to as the purchase price.
- Financial diligence assesses various performance aspects of a company, and perhaps most importantly adjusted EBITDA – which helps validate enterprise value and other impacts to the ultimate purchase price.

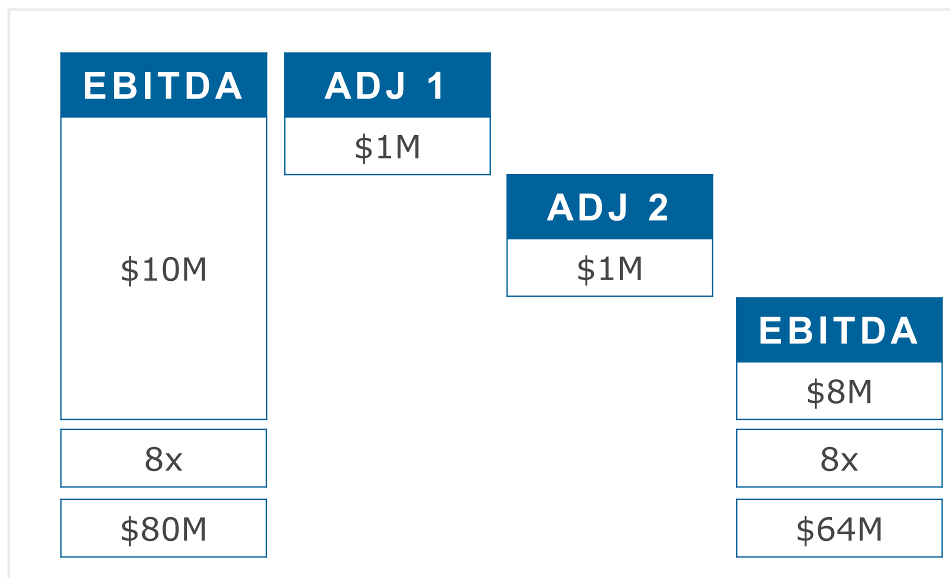
HOW DOES DUE DILIGENCE RELATE TO FAIR VALUE?



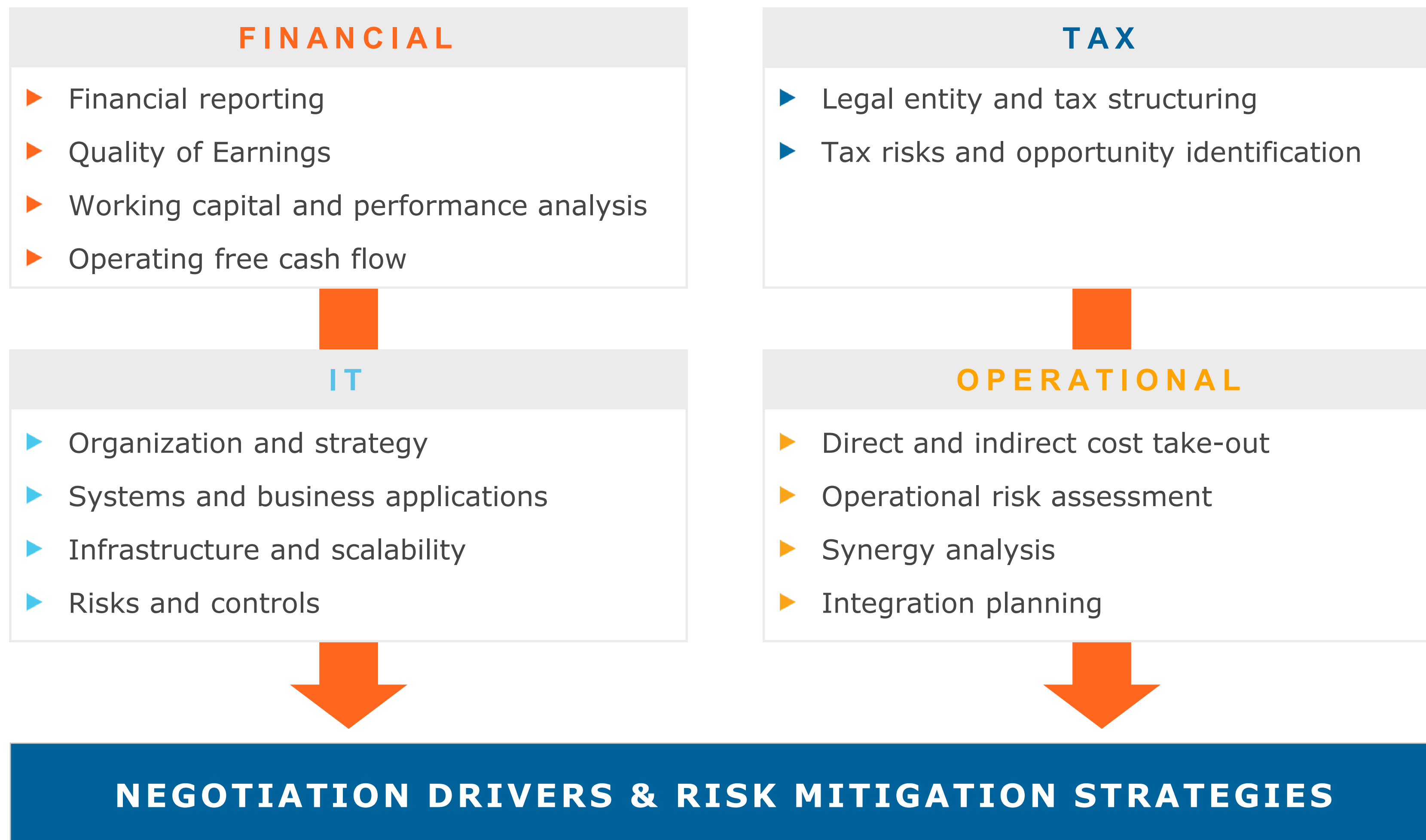
HOW DOES DUE DILIGENCE RELATE TO FAIR VALUE?

- Negotiations often start with Target providing historical financial information and forecasted expectations
  - Not surprisingly, these expectations can be on the rosy side
- Due diligence helps to identify factors that should be included in the assessment of the Target
- Examples include:
  - Non-recurring revenue
  - One-time gains or losses





WHAT ELSE DOES DUE DILIGENCE COVER?



MORE ON FINANCIAL DUE DILIGENCE

- Key outputs of **financial due diligence** are a **quality of earnings** (normalized EBITDA analysis), assessment of the target company's **financial position** (balance sheet analysis) and **adjusted working capital trends** (cash conversion performance).
- Additionally, **debt-like items, accounting processes and the quality of information** and reporting are typically assessed.

Common issues identified in financial due diligence:

Inaccurate financial information	Concentration or risks with customers or vendors
Identification or adjustment for non-comparable results	Working capital volatility, seasonality, or anomalies
Impacts to EBITDA resulting from historical non-operational, out-of-period, erroneous reporting, non-cash, or non-recurring activities	On or off-balance sheet debt-like items
	Significant capital expenditures, or other impacts to operating free cash flow

TYPICAL SCOPE OF FINANCIAL DUE DILIGENCE

Focus areas typically covered in financial due diligence include:

Focus area	Description
Historical quality of earnings	to analyze the trends in reported earnings of the target company and determine whether those earnings are recurring and will continue to add value to the owner's capital
Working capital analysis	to identify seasonal swings, analyze volatility, and understand payment terms with vendors and customers. Propose adjustments and arrive at a normalized level expected at closing (target or peg)
Capital expenditure requirements	to understand the funds required to maintain and/or grow operations
Debt and debt-like items	to identify items to be negotiated as indebtedness, and ensure debt held has rationale behind it or aligns with an investor's acquisition thesis
Business operations	to analyze business operations and how performance compares to expectations in a given industry in which it operates; identify non-operational activities

OTHER FINANCIAL DUE DILIGENCE AREAS

QUALITY OF REVENUE

STAND-ALONE ANALYSIS

BREAK-EVEN ANALYSIS

PROOF OF REVENUE

FREE CASH FLOW

CUSTOMER CHURN, MRR

REVENUE CHANNEL & CUSTOMER ANALYSIS

SYNERGY ANALYSIS

SAME STORE GROWTH

GAP TO FORECAST ANALYSIS

PRICE-VOLUME

GROWTH MODEL ASSESSMENT

CARVE-OUT ASSESSMENT

BEST PRACTICES

1	Financial due diligence, combined with other focus areas, is critical to validating the true value of a business.
2	In addition to financial due diligence, buyers who thoroughly analyze tax, IT, operational, and other areas of the target are better informed when evaluating the entire investment opportunity and related risks, in addition to **preparing for integration and first 100-day plans.**
3	Buyers who use a multidisciplinary and **integrated approach** to diligence will be positioned to **mitigate risk or extract value at close** through negotiation, purchase agreement terms, and representations and warranties/insurance among other methods.
4	Conducting a rigorous and continual assessment of fair value and ultimate purchase price in line with **diligence findings will drive value realization.**

Polling Question # 3

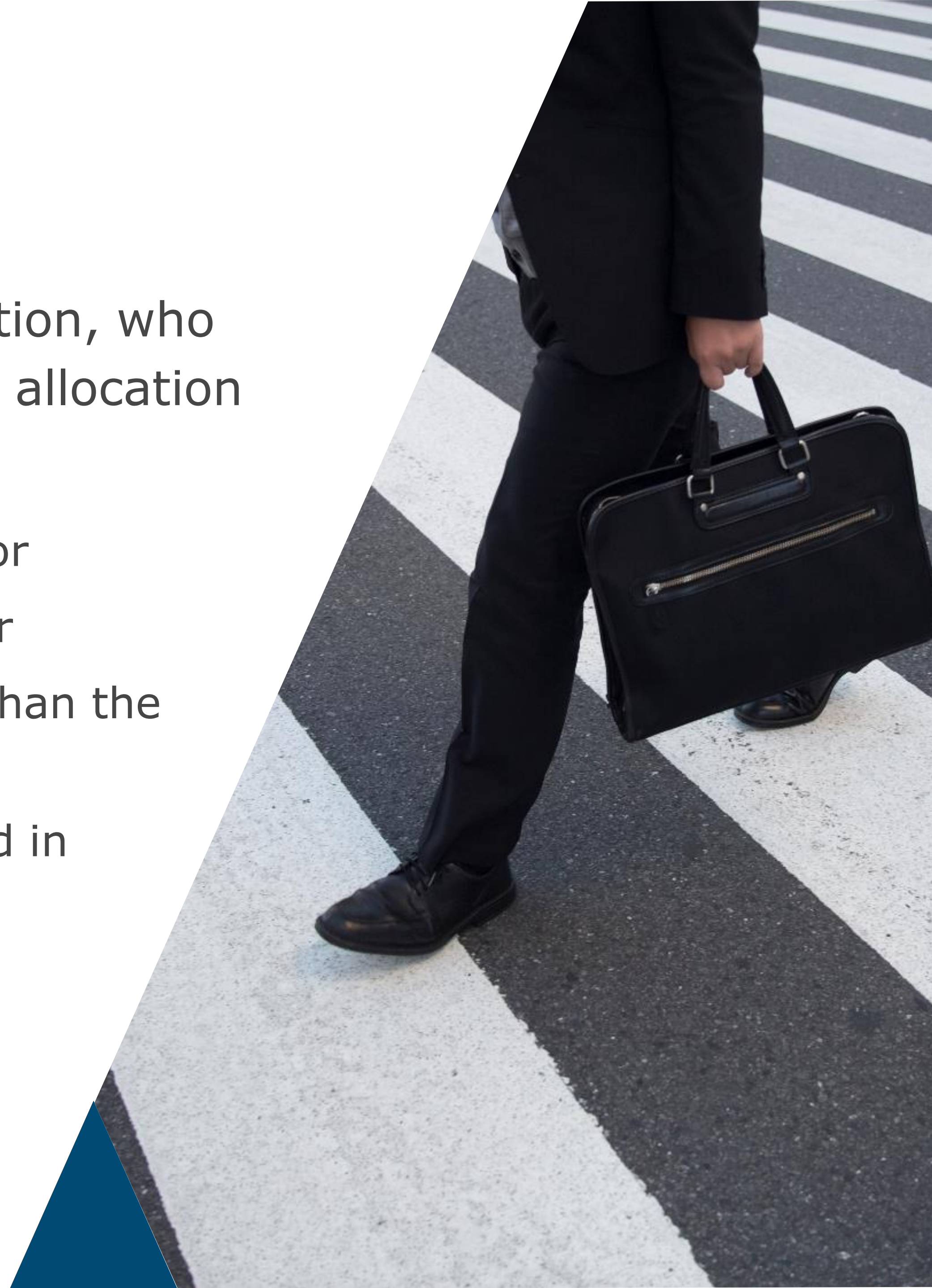
In your most recent transaction, who prepared the purchase price allocation and opening balance sheet?

A. Third-party diligence advisor

B. Acquirer's CFO or Controller

C. An accounting firm (other than the auditor)

D. Don't know, wasn't involved in transaction



PURCHASE PRICE ALLOCATIONS

Key considerations

PURCHASE PRICE ALLOCATION

The purchase price allocation is the process through which the fair value of the total consideration paid for a business is allocated between the assets acquired and liabilities assumed.

- Required under US GAAP when there is a change in control of a business
- Acquired assets and liabilities are stated at Fair Value (with limited exceptions)
- Residual value between the total consideration transferred to the seller and the sum of the acquired assets and liabilities assumed is goodwill

The purchase price allocation process provides the buyer with insights about many aspects of the business and its value drivers.

DETERMINE THE PURCHASE PRICE

- The purchase price is the total amount of consideration transferred from the buyer to the seller
- If consideration paid to the seller includes anything other than cash, the acquisition-date fair value of the consideration must be determined
- If the purchase involves payments that are contingent on future events or conditions, such as an "earn-out", the fair value of such contingent consideration should be determined and included in the total purchase price as of the acquisition date

IDENTIFYING ASSETS ACQUIRED AND LIABILITIES ASSUMED AND DETERMINE THEIR FAIR VALUES

- An understanding of the business and the nature of the transaction is necessary to properly identify the assets acquired and liabilities assumed
- The common types of assets and liabilities which may require a valuation to determine their respective fair values in a purchase price allocation include:

ASSETS

- Inventory
- Machinery & equipment
- Real estate
- Intangible assets, such as:
  - Customer relationships
  - Software and technology
  - Trade names
  - Off-market contracts, including leases

LIABILITIES

- Contingent consideration (e.g., an earn out)
- Payables and debt
- Site restoration obligations
- Deferred revenue

EXAMPLE PURCHASE PRICE ALLOCATION

Company A acquired Target B for a combination of $85 million cash paid at closing plus an "earn out" representing potential additional payments at the end of each of the next two years, contingent upon the achievements of certain EBITDA metrics. A working capital adjustment also resulted in an additional payment of $1 million to the seller.

A valuation specialist determines that the fair value of the earn-out, or contingent consideration, is $14 million at the date of acquisition.

Thus, the fair value of the total purchase consideration transferred to the seller of Target B is determined to be $100 million ($85 million + $1 million + $14 million).

Company A, as the acquirer, must perform an allocation of the total purchase price.

EXAMPLE PURCHASE PRICE ALLOCATION

- Company A identifies the tangible and intangible assets (including customer relationships) acquired and liabilities assumed
- The assessment of a valuation specialist determines that the fair values of the acquiree's net identifiable assets and liabilities assumed is $80 million
- Company A allocates the total purchase consideration of $100 million to the acquired assets and liabilities assumed, with the excess purchase price recorded to goodwill

	TARGET B CLOSING BALANCE SHEET	FAIR VALUE ADJUSTMENTS	ACQUIREE'S OPENING BALANCE SHEET
Tangible assets & NWC	$70	$5	$75
Customer relationships	--	15	15
Goodwill	--	34	34
Liabilities assumed	(10)	--	(10)
Contingent consideration	--	(14)	(14)
Invested Capital			$100

Polling Question # 4

What are the biggest challenges in determining the fair value of an acquiree's assets and liabilities for purchase accounting?

A. Gathering the right data inputs

B. Using the right methodology

C. Getting the auditors to sign off

D. All of the above, so I use a valuation specialist to do this

COMMON VALUATION METHODS

The Basics

COMMON METHODS USED TO VALUE INTANGIBLE ASSETS

- Intangible assets acquired in a business combination must be stated at Fair Value on the acquisition date.
- Below are examples of intangible assets and common valuation approaches and methodologies used to determine fair value. Selection of the method is based on factors about the company, industry, and determination of the "primary asset", amongst other factors.

INTANGIBLE ASSET	VALUATION APPROACH	VALUATION METHODOLOGY
Trade Name	Income	Relief From Royalty
Technology	Income	Relief From Royalty
Non-Compete Agreements	Income	With Or Without
Permits	Income	Greenfield
Customer Relationships	Income	Excess Earnings
Internally Used Software	Cost	Replacement Cost

RELIEF FROM ROYALTY	WITH AND WITHOUT METHOD	EXCESS EARNINGS APPROACH
Premise is that if one didn't own the asset, it would pay a royalty to a third-party for its use. Therefore, by owning the trade name, one is "relieved" of having to pay to license the asset.	Comparison of cash flows of the business with the asset in place and without the asset in place. "With" scenario is the base business forecast "Without" scenario factors in lost sales, changes in direct and indirect costs, and the time period to recreate or replace the asset.	Premise is that an income stream for a collection of assets (a business) can be adjusted to isolate the return to the subject asset (e.g., customer relationships).

Key Inputs:
▶ Projected revenue associated with the asset
▶ Obsolescence (Technology related assets) - capturing the rate of change in the technology. Need to exclude future development from the valuation on Day 1
▶ Royalty rate - determined by reviewing market agreements, qualitative assessments, and profitability metrics
▶ Intended use of the name – from a market participant perspective
▶ Discount rate that reflects the risk associated with the assets
	Key Inputs:
	▶ Term or period of the agreement
	▶ Ability of the seller to take business
	▶ Time period over which the business will recover
	▶ The likelihood of occurrence
		Key Inputs:
		▶ Forecasted cash flows related to the collection of assets
		▶ Adjust the cash flows by deducting "economic rents" – aka contributory asset charges – for supporting assets
		  ▶ Concept similar to renting or licensing all assets needed to generate the cash flows for the business.
		  ▶ The remaining cash flows are the "excess earnings" related to the subject asset
		▶ Discount rate that reflects the risk associated with the assets
		▶ Other important inputs include customer churn rate and future growth related to current customers

ADDITIONAL RESOURCES

Related Thought Leadership

2020 Corporate Development Officer Study: Best Practices and Benchmark Trends

Integrated Diligence: Bringing Continuity to the Transaction Lifecycle

View additional insights **HERE**

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