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Using the Distributor Method to Value Customer Relationships

By PJ Patel, CFA, ASA, and Ed Hamilton, CFA

A common framework when valuing intangible assets of a business—such as brands, trademarks, and technology—is to use the relief from royalty method, combined with the multiperiod excess earnings method (MPEEM), to appraise customer relationships. This framework requires significant market evidence, especially at the asset level, because of the challenge of finding royalty indications that are directly comparable to the asset being valued. Therefore, in certain industries and situations, this framework may be highly subjective and, if applied in a mechanical

Applying the Distributor Method in Australia

Editor's note: Leadenhall Corporate Advisory Pty, Ltd is part of a global group of valuation experts, Valuation Research Group (VRG). The U.S. member of VRG is Valuation Research Corporation (VRC). PJ Patel and Ed Hamilton of VRC discuss the use of the distributor method to value customer relationships, which often results in a value for customer relationships that makes more sense in the overall context of the business.

When preparing purchase price allocations (PPA) in Australia, it is common to apply:

- A relief from royalty method to value any material brand names; and
- A multiperiod excess earnings methodology (MPEEM) to value customer relationships.

Often as part of this process, market-observed royalty rates are adjusted to obtain an allocation that reflects the commercial reality of the underlying business and the relative importance of the intangible assets. Sometimes this adjusted result still does not result in an allocation of the purchase price that reflects the economic importance of the various identified intangible assets.

While the distributor method is not commonly applied in Australia, it has been used by VRC for several years on many large transactions and is included in the Appraisal Foundation's best practice document 'The Valuation of Customer Related Assets'.

The method relies on determining an EBIT margin for a 'distributor' and then applying that normally significantly lower EBIT margin in the MPEEM calculation (rather than the margin for the company itself). An excess margin calculation is then undertaken to value the brand.

This methodology would generally result in a significantly higher value for the brand and significantly lower value for the customer relationships than the normally applied methodologies. It would be appropriate to apply the methodology where the primary asset acquired is the brand and the business's customers want the product because consumers demand it. For example, in undertaking a purchase price allocation of a consumer product company (such as the CocaCola company), the classic method results in a disproportionally large value allocated to customer relationships, where the reality is a significant larger value should be allocated to the brand.

We hope this article provides Australian users with additional methodologies that they can utilise in undertaking PPAs.

Additional information on the methodology (including a more detailed presentation) is available by contacting Simon Dalgarno, director (08 8385 2207), or Richard Norris, senior adviser (02 8823 6224), both of Leadenhall Corporate Advisory.

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manner, may provide a value conclusion that is inconsistent with a qualitative assessment of the entity and its underlying assets. As an alternative, in certain situations, we replace the company-specific margin with a market-based margin, as a reasonable market proxy, in an MPEEM. This method is commonly referred to as the distributor method (DM). The name is derived from the initial use of distribution companies as the market proxy. Subsequently, extensions have been developed for other situations.

When a company has strong and unique intellectual property, such as a brand or technology, limited though material value to the customer relationship may exist. A leading brand with strong recognition generates its own demand, and customers (retailers and distributors) carry the brand due to consumer demand. The company benefits from having the customers in place as they enable the company to reach the consumer. This situation, a relationship based on the ability to provide the desired product in a timely and efficient manner, is analogous to that of a distributor. A distributor's relationships with its customers are contingent upon it providing a desired product in a timely manner. Additionally, the distributor's operating margin is reflective of the relative importance of the IP vs. the customer relationship. The more unique or proprietary the distributor's products, the lower the margin typically earned and the lower the value contributed by the customer relationship function. The less unique, and thus the relatively greater value added by the customer relationships, the higher the margin.

Exhibit 1 demonstrates this inverse relationship. A distributor carrying a unique product, e.g., a branded pharmaceutical, earns a lower margin because the customer seeks a specific product. The relationship is merely a channel to the product.

An alternative example demonstrates the varying value drivers of two brands sold in a retail setting. Brand A is the leading brand with strong brand equity. It earns a margin that is above that of other products in the same space. Brand B is a secondary brand. Customers purchase it largely on price, and competitors with similar levels of brand equity

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exist. It earns a margin at the lower end of market observations. If a valuation practitioner applied the traditional framework using market observations of royalty rates to value the trademark, the incremental margin would largely accrue to the customer relationships, which is inconsistent with a qualitative assessment of the business drivers.

In fact, the opposite is likely appropriate; after appropriate charges for use of supporting assets such as customer relationships, fixed assets, and working capital, all economic value should accrue to the brand. This is demonstrated in Exhibit 2. As the total margin increases, the portion attributable to the brand increases as well.

Case study. A large consumer packaged goods company engaged us for a project related to its acquisition of a leading manufacturer and distributor of snacks. The acquired brands were iconic in their region. Formal data and anecdotal evidence demonstrated the strength of the brand. Market research indicated strong brand equity, and anecdotal evidence abounded in support of the brands. There were tales of stores deciding not to carry the brand and losing customers.

Exhibit 1. EBIT Margin by Distributor Type

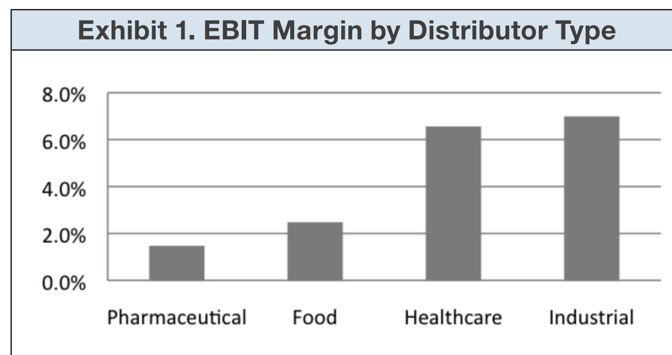
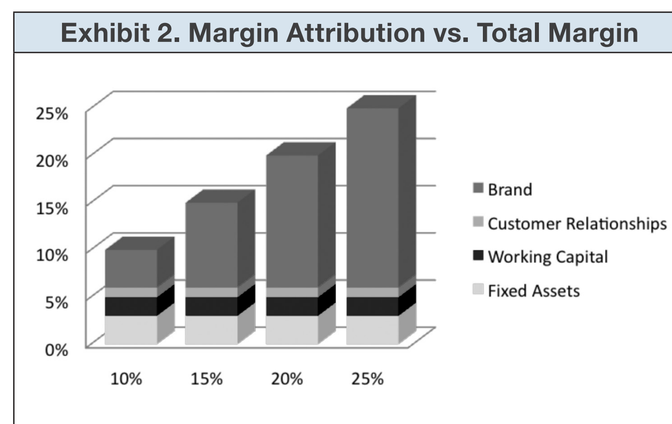


Exhibit 2. Margin Attribution vs. Total Margin



There were consumers who refused to go to stores that did not carry their favourite products.

Additionally, the company's customers—retailers—carried the brand because of customer demand, not because of their relationship with the company. As such, the company does benefit from having an assembled base of retailers and the related ability to reach consumers. Based on these factors as well as the similarity of the relationships the company holds with its customers and the relationships distributors hold with their customers, we decided to apply the distributor method (use of distributor inputs in the MPEEM) to value the customer relationships. In turn, we utilised the MPEEM using the prospective financial information (PFI) to value the brand. We determined that this method was less subjective than the traditional approach of trying to select an appropriate royalty rate from a list of royalty rates of limited comparability.

Calculation discussion. We estimate the value of the customer relationships by applying the fundamental data (margin and contributory asset charges) of a distributor to the revenue stream associated with the relationships being valued. In applying this calculation, the method disaggregates the value added by specific business processes/IP. This method may also be viewed as a profit split. Importantly, the key inputs, particularly the margin and contributory asset charges, are based on those of the distributors. The margin is lower than the brand margin since any IP, including technology and brands, is captured within the distributor's cost of goods sold.

Additionally, contributory asset charges (CACs) are consistent with a distributor—fixed assets are those used in distribution, not manufacturing—and are typically lower than that of a manufacturer. Working capital is that of the distributor and may be higher or lower than that of a manufacturer, depending upon working capital practices within a given industry. The CAC for use of the workforce is likely lower than for the IP owner as it only includes individuals involved in sales and distribution, as opposed to IP-related functions including R&D and marketing. For a distributor, the workforce CAC may even be

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immaterial. In this example, the income stream was not adjusted for a CAC for the use of the distributor's trade name, as we considered the importance of this factor immaterial. In other cases, it may be appropriate to apply a CAC for one or more of these assets. It is important however, that they be the assets of the distributor (distributor corporate name or logistical software), not the assets of the brand/subject entity (brand name or proprietary manufacturing processes).

Exhibit 3. Use of Distributor Method to Estimate the Value of Customer Relationships

		Year 1	Year 2	Year 3	Year 4	Year 5
Revenue at Acquisition		360,652				
Revenue Adjusted for Growth		360,652	364,259	367,901	371,580	375,296
Remaining After Attrition		100.0%	95.0%	90.3%	85.7%	81.5%
Revenue After Attrition		360,652	346,046	332,031	318,584	305,681
EBITA		14,787	14,188	13,613	13,062	12,533
Less: Income Taxes		5,915	5,675	5,445	5,225	5,013
Debt Free Net Income		8,872	8,513	8,168	7,837	7,520
Debt Free Net Income Margin		2.5%	2.5%	2.5%	2.5%	2.5%
Returns on Supporting Assets						
Normal Working Capital		(2,597)	(2,492)	(2,391)	(2,294)	(2,201)
Property, Plant & Equipment		(902)	(865)	(830)	(796)	(764)
Workforce		(469)	(450)	(432)	(414)	(397)
Return on Supporting Assets		(3,967)	(3,807)	(3,652)	(3,504)	(3,362)
		-1.1%	-1.1%	-1.1%	-1.1%	-1.1%
Net After Tax Cash Flow to Customer Relationships		4,905	4,706	4,516	4,333	4,157
Implied Royalty Rate		1.4%	1.4%	1.4%	1.4%	1.4%
Partial Period Adjustment		1.000	1.000	1.000	1.000	1.000
Period		0.500	1.500	2.500	3.500	4.500
Discount Factor		0.933	0.811	0.705	0.613	0.533
PV of Cash Flow		4,574	3,816	3,184	2,657	2,216
PV of Cash Flows		26,873				
Tax Benefit=L/(L-(Fa*T))						
Tax Life	15 Years					
Tax Rate	40.0%					
Discount Rate	15.0%					
Amortization Factor	6.2706					
Tax Benefit	20.1%	5,396				
Fair Value		32,269				
Fair Value (Rounded)		**32,000**				
Assumptions						
EBITA Margin		4.1%	4.1%	4.1%	4.1%	4.1%
Growth of Retained Customers		1.0%	1.0%	1.0%	1.0%	1.0%
Attrition		5.0%	5.0%	5.0%	5.0%	5.0%
Tax Rate		40.0%	40.0%	40.0%	40.0%	40.0%
WC to Revenue Ratio		9.0%	9.0%	9.0%	9.0%	9.0%
Return on WC		8.0%	8.0%	8.0%	8.0%	8.0%
PP&E to Revenue Ratio		2.5%	2.5%	2.5%	2.5%	2.5%
Return on PP&E		10.0%	10.0%	10.0%	10.0%	10.0%
Workforce		0.1%	0.1%	0.1%	0.1%	0.1%
Discount Rate						

Note: The calculation extends for 20 years; five are shown for display purposes.

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We can capture the incremental value (in this case, largely reflected in a brand margin that substantially exceeds the margin used to value the customer relationships but also in differing contributory asset charges) via other valuation methodologies and ascribed it to the appropriate asset (in this case, the brand). Note that application of the DM without use of a brand/company level MPEEM would likely leave a substantial portion of the margin/economic profit unaccounted for and thus include it as goodwill. In practice, we have never used the DM to value customer relationships if the MPEEM using the full Prospective Financial Information was not used to value another asset.

Other attributes of the DM are similar to the traditional MPEEM. Inputs such as revenue, growth rates, and attrition rates are needed. These inputs are typically the same whether viewed from a distributor or brand-specific perspective. Exhibit 3 illustrates the use of the distributor method (use of distributor inputs in the MPEEM) to estimate the value of customer relationships for a transaction in the consumer products industry.

Extensions. There may be additional situations where a selected group of companies provides an appropriate proxy for the customer relationship function. An example is an industry in which certain companies have proprietary IP and others do not. Those without proprietary IP would likely have lower margins and may, for purposes of valuing the customer relationships, provide reasonable inputs in the same manner as a distributor's in the case study above. Similarly, the MPEEM using the PFI would then be used to value another asset, which would likely be the IP.

Acceptance of the method. VRC has used the DM for several years. During this time, we have found both interest and acceptance in terms of its use. Generally, it has been widely accepted when applied in the manner discussed. It is also in the Appraisal Foundation's best practice document 'The Valuation of Customer-Related Assets.'

Conclusion. The distributor method is a powerful tool for the valuation of customer relationships in situations where these relationships are a supporting asset and where there are appropriate market inputs—based on comparable companies—which have customer relationships that are analogous to those of the subject entity. This method also allows the use of the MPEEM using the PFI for the valuation of another asset including a primary asset or unique IP. In situations where its use is appropriate, it is nearly always a less subjective valuation methodology.

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