Case Study

An Enterprise Solution Provider

Service(s) offered: **Purchase Price Allocation (PPA) for Financial Reporting purposes**
Sector/Industry: **Enterprise Technology**

Carried out a Purchase Price Allocations study for Financial Reporting for a major P.E. Fund

A technology focused Private Equity fund (Fund) had acquired the enterprise solutions division (Division) of a publicly traded company (Company). The Division was involved in providing integrated enterprise multi-portfolio lending systems for banking, financial services, credit management, and revenue collection for the Insurance and Telecom industry.

The Fund / Division (Client) approached Nexdigm to assist with identification of the intangible assets acquired as part of the software division acquisition, the purchase price allocation (PPA) of the consideration paid for financial reporting purposes.

Approach

Our approach was divided into the following phases:

Phase I - Understanding the Business and Industry dynamics, which included:

- Scrutinizing the agreements to determine the scope of the transaction
- Understanding the scope of business and market to identify the micro/macro economic factors which affected performance parameters of the business
- Identifying intangibles for the management
- Evaluated the eligibility of tax benefits on the identified intangible assets.

Phase II - Evaluation of Valuation Approaches/ Methodologies, which included:

- Fair valuation of the identified intangible assets
- Evaluating the impact of the "earn-out clause" on the purchase consideration
- Arriving at the resultant goodwill/capital reserve.

Phase III - Valuation of the Target, which included:

- Assisting the Client with Audit Review of the PPA
- Assisting in Accounting for the transaction

Phase I - Research

The transaction between the Company and the Fund was structured in a manner wherein first the Company sold the Division to a new wholly-owned subsidiary (WoS) via a slump sale and later transferred the shares of the WoS to the Fund which contained a contingent earn-out clause.

Due to the complex transfer, we scrutinized the Share Transfer Agreement, the Business Transfer Agreement, and the Share Purchase Agreement. We used these to analyze how rights and obligations were being transferred between parties.

Based on an in-depth understanding of the business and the agreements, we identified the company's trademarks, internally developed software, customer relationships and workforce as the Intangible Assets.

Thereafter, we evaluated legal precedents to assess the eligibility for Tax Benefits on such intangible assets under the Indian Income Tax Act.

Phase II – Evaluation of Methodologies

We then evaluated the different valuation methodologies that could be applied to ascertain the valuations of each identified intangible.

Accordingly, the most suitable methods were established and applied to value the intangibles:

Trademark

Upon careful consideration, we applied the Relief from Royalty Method. The method included:

- Estimating the portion of revenue attributable to the trademark
- Searching international databases like Royaltystat, Royaltysource, etc. for trademark licensing agreements in similar industries
- Adopting a Royalty rate based on the available market information
- Assessing the required return on trademark i.e. discount rate
- Calculating tax savings associated with amortization (TAB).

Internally Developed Software (IDS)

For this software, we applied the Multi Period Excess Earning Method, which involved:

- Estimating the revenues, expenses and margins attributable to such IDS
- Estimating the Obsolesce/Decay Rate
- Calculating Contributory Asset Charges
- Assessing the required return on IDS i.e. discount rate
- Calculating the tax savings associated with amortization (TAB).

Customer Relationships

The Multi Period Excess Earning Method was identified as most suitable, which involved:

- Apportioning the revenues, expenses and margins attributable to existing customer base
- Estimating the customer switching rate
- Distributing selling & marketing expenses
- Calculating contributory asset charges
- Assessing the required rate of return, i.e., the discount rate
- Calculating the tax savings associated with amortization (TAB).

Workforce

We applied the Replacement Cost Method. It involved:

- Estimating the average training and recruitment expenses per employee for each functional category
- Estimating the average starting efficiency for each identified functional category, as well as the time it takes for employees to achieve full productivity

After valuing all the intangible assets, we calculated the Weighted Average Return on Assets (WARA) for the given mix of assets and reconciled the WARAwith the WACCand IRR. To conclude on the resultant goodwill/capital reserve from the transaction, we further analyzed the earn-out clause of the agreement to arrive at the total purchase consideration.

Phase III - Valuation

Once the intangible assets were identified and valued, and resultant goodwill arrived at, we presented our analysis to the client in the form of a detailed Purchase Price Allocation Report.

The Nexdigm team also assisted the Client's accounts & finance team with accounting for the PPA report findings.

Further help was extended to the Client with regard to addressing all the queries of the statutory auditors vis-a-vis the transaction and the PPA.

Impact

Our holistic solution helped the Client right from the intangible asset identification stage through the audit review. Our Client centric approach, not only assisted the Client with PPA but also analyzed the implications of the PPA from Tax and Accounting laws perspective to provide the Client with the most efficient solution.

For more information on this case study, please write to us at:

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You can also visit our website to know how our services resulted in tangible business benefits:

www.nexdigm.com