Case Study

A Listed Indian Pathology and Diagnostic Service provider

Service(s) offered: Due Diligence & Valuation

Sector/Industry: Healthcare

Identification and valuation of intangible assets to determine the Purchase Price Allocation (PPA) for Financial Reporting Purposes

A listed Indian Pathology and Diagnostic Service provider (Client/Acquirer) had acquired a majority stake in a local pathology and diagnostic chain to strengthen the Client's presence in Central India. The pathology and diagnostic chain's business, comprising of 7 labs, 100+ collection centers, and 300+ Pick-up-Points, functioned under two legal entities - a proprietorship concern (the Proprietorship) and a partnership firm (the Firm) (collectively Targets), both owned and operated by a renowned doctor.

Before the acquisition, the Targets were consolidated into a new legal entity (the Company) formed specifically for this purpose. This consolidation took place through two slump sale transactions wherein the Firm and the Proprietorship sold their respective businesses on a going-concern basis to the Company (collectively referred to as the Transaction). Thereafter, the Client acquired 70% of the Company through its wholly-owned subsidiary.

The Client approached Nexdigm to assist with the identification of the intangible assets acquired as part of the Company's acquisition and the Purchase Price Allocation (PPA) of the consideration paid for financial reporting purposes.

Approach

Nexdigm's approach was divided into the following phases:

1. Understanding the Business & Industry Dynamics and Identification of Intangible Assets
2. Evaluation of Valuation Approaches/Methodologies and Valuation of Intangible Assets
3. Purchase Price Allocation (PPA) and Accounting for the Transaction.

Phase I - Understanding the Business & Industry Dynamics and Identification of Intangible Assets

Due to the complex structure of the Transaction, we scrutinized the Business Transfer Agreements and we used these to analyze how the rights and obligations were being transferred between the entities.

Based on an in-depth understanding of the business and the agreements, we identified trademarks, non-compete agreements, customer relationships, and assembled workforce as intangible assets held by the by the Company.

- **Trademark:** The entire revenue was attributed to the registered trademark of the Firm. The Firm's trademark was well known in Central India and therefore was The entire revenue was attributed to the registered trademark of the Firm. The Firm's trademark was well known in Central India and therefore was valuable as it would take significant time and cost to establish a similar trademark. The Client had avoided the cost of obtaining the trademark directly or paying a royalty for its use, and hence trademark was considered integral to the Transaction.
- **Non-Compete Agreement:** A non-compete was executed between the Doctor (the Proprietor/significant partner of the Firm) and the Client. The Acquirer had avoided the risk of the Doctor's expertise or network being used anywhere else except in the Company. Building a patented network and reputation would take significant time and cost, therefore, this non-compete arrangement was integral to the Transaction.
- **Customer Relationships:** Those relationships that cause customers to do business with an entity on an ongoing basis are called customer relationships. Such existing customers were perceived as valuable as they provide the Acquirer with continuing business opportunities with low or no additional cost in terms of marketing and sales that would normally be incurred to attract new customers. The list of customers included numerous hospitals, corporates, labs, and government agencies.

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

Furthermore, the purchase price for the acquisition of 100% of the Firm and Proprietorship was accompanied by a contingent consideration. This contingent consideration was based on:

- The achievement of revenue with the growth of at least 30% in the coming financial year
- Adjustment of the difference in the normalized working capital of the Targets compared to the actual working capital

After analyzing the projections of the Targets and discussions with the Client, Nexdigm concluded that such growth is not expected to be achieved. Consequently, the contingent consideration was considered nil for the Transaction.

Based on the above observations, we prepared a PPA Note for the Client's auditors which summarized business understanding, transaction understanding, and proposed methods to value the identified intangible assets to help with the Audit Review and minimize audit queries.

Phase II - Evaluation of Valuation Approaches/Methodologies and Valuation of Intangible Assets

We evaluated the different valuation methodologies that could be applied to evaluate each identified intangible. Accordingly, we used the most suitable method to value each of the identified intangibles:

- **Trademark**

The Relief from Royalty Method was considered the most suitable methodology to value the trademark. The methodology entailed:

- Estimating the portion of revenue attributable to the trademark
- Screening similar agreements for trademark licensing agreements in comparable industries and estimating a Royalty Rate based on the 25% Profitability Rule of Thumb
- Assessing the required return on trademark (discount rate)
- Calculating tax savings associated with amortization (TAB)

- **Non-Compete Agreement**

The With and Without Method was considered the most suitable methodology to value the Non-Compete Agreement. The methodology entailed:

- Projecting revenue, assuming with and without the non-compete agreement being executed
- Apportioning relevant expenses
- Applying the income tax rate
- Adjusting the cash outflow on account of capital expenditure

- Adjusting incremental working capital, assuming with and without the non-compete agreement being executed
- Estimate the probability of competition (considering that the Doctor would continue to own 30% of the business)
- Assessing the required discount rate
- Calculating the tax savings associated with amortization (TAB)

- **Customer Relationships**

The Multi-Period Excess Earning Method was considered the most suitable methodology to value Customer Relationships. The methodology entailed:

- Apportioning the revenues, expenses, and margins attributable to the existing customer base
- Estimating the customer attrition rate
- Assessing distribution-related selling and marketing expenses
- Calculating contributory asset charges
- Assessing the required discount rate
- Calculating the tax savings associated with amortization (TAB)

- **Assembled Workforce**

The Replacement Cost Method was considered the most suitable methodology to value the Assembled Workforce. The methodology entailed:

- 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
- Estimating the loss of productivity cost per employee for each function (based on starting efficiency and time to achieve full productivity)

We calculated the Weighted Average Return on Assets (WARA) for the given mix of assets and reconciled the WARA with the Weighted Average Cost of Capital (WACC) and the Internal Rate of Return (IRR)for the Targets.

The excess purchase consideration for the Targets was calculated as the difference in the purchase consideration paid for the Firm and Proprietorship, and the total of the net identified tangible and intangible assets acquired.

Phase III - Purchase Price Allocation – Audit Review and Accounting

Once the intangible assets were identified and valued, the excess purchase consideration paid by the Acquirer was allocated to the goodwill amount. We presented our analysis to the Client in the form of a detailed Purchase Price Allocation Report.

We also helped the Client address all queries of the statutory auditors for the transaction and the PPA and, after that, assisted the Client's accounts and finance team in accounting for the PPA.

Conclusion

Nexdigm's holistic solution assisted the Client right from intangible asset identification till the Audit Review stage. Nexdigm's proactive approach in preparing a PPA note in Phase I streamlined the audit process and minimized audit queries during the Audit Review.

Our approach assisted the Client with the PPA and analyzed the implications of the PPA from a tax and accounting laws perspective to provide the Client with a holistic solution.