Intangible Asset Valuation
Valuing Customer Relationships

What are Intangible Assets?

An intangible asset is an identifiable non-monetary asset without physical substance. Some examples of intangible assets are Trademark, Brandname, Software, Technology, Customer Relationships, and Goodwill.

To recognize an intangible asset, the following three criteria need to be met:

1. Identifiable

An intangible asset must be identifiable. Identifiable means the asset should either be separable or arise out of a contract (for example, franchise rights) or arising out of law (for example, copyright), whereas goodwill is not separable.

2. Control

An intangible asset must be controlled by a particular entity.

3. Future Economic Benefits

By virtue of owning/controlling an intangible asset, an entity must accrue an economic benefit in some form.

Customer-related Intangible Assets

Customer-related intangible assets arise out of a pre-existing relationship between an entity and its customer. A relationship can be contractual or merely based on an entity possessing relevant information about its customer.

Consider a situation where two competitors – Company A and B –operate in the same business line and have the same brand recognition. However, Company A has an established customer base and has collected customer data on purchasing habits, contact information, and other related data, whereas Company B is primarily reliant on the wholesale channel to market its products. How would you value them? To value Company A using similar parameters as Company B would be unreasonable as Company A has long-term direct relationships with its customers and has strategically used its customer data for supply chain management, etc. This provides Company A with a competitive edge, and Company B faces a barrier to entry as it does not possess similar insights into customer behavior and preferences. This advantage will reflect in superior operating margins of Company A.

A real-world instance of the same can be seen in the Indian Paint Industry. In the 1970s, Asian Paints revolutionized its business model by discontinuing its earlier business model that relied on traditional dealerships/wholesalers and started supplying inventory directly to the retailers. Simultaneously, Asian Paints started using the power of a mainframe computer to manage and track inventory right from the point of production to the point of sale (retailers). This produced a treasure trove of insights into consumer behavior while eliminating 30-35% dealer commission. The market capitalization of Asian Paints versus its peers clearly reflects the value add and importance of customer relationships.

Types of Customer-related Intangible Assets

1. Customer Relationships

Customer relationships can be contractual and non-contractual. If the entity develops a relationship with customers through contracts, they meet the criteria of separability, control, and possible future economic benefit. If this relationship arises out of non-contractual rights, they have to meet the criteria of separability to be recognized as an intangible asset. An example of a non-contractual relationship would be submitting personal data to participate in promotional activities such as a lucky draw.

2. Customer Lists

A customer list is a form of customer-related intangible assets consisting of customer information - their names, contact information, sales generated, etc. This list can further be divided into different databases based on demography, zones, age groups, etc., which helps businesses target products/services according to their target audience. Customer lists are created by an entity when engaging with customers over a long-term . These relationships can be contract-based or non-contractual.

3. Order Book or Order Database

These are sales orders and purchase orders generated over the course of regular business activities. These orders meet the recognition criteria even if the contracts are cancellable.

Some real-world examples of creating, defending, and monetizing customer-related intangibles include:

1. Tech giants like Google and Facebook provided their platforms for free to users and, over time, collected valuable data about their users. Now these tech giants gain the majority of their revenue through advertisement (advertisements target users based on the data these tech giants gather regarding user behavior and advertisement preference).
2. Facebook had been losing its younger demography to other social networking sites/apps like Instagram and Snapchat. To regain its influence over this demography, Facebook acquired Instagram in 2012. Today, Instagram is more valuable than Facebook.
3. Paytm, which collected large amounts of data by facilitating millions of transactions, is planning to open a business consultancy service on the basis of data collected by them. These services aim to facilitate small and medium businesses in identifying locations to set up operations/attract customers through the insights. Paytm has gained a competitive edge by analyzing large amounts of data.

Customer relationships are generally the most important and valuable customer-related intangible acquired during a business acquisition. Therefore, let us evaluate how and if various valuation approaches can be used to value customer relationships.

Valuation Approaches

1. **Income Approach**
    - Multi-Period Excess Earnings Method (MPEEM)
    - With or Without Method
    - Distributor Method
2. **Market Approach**
3. **Cost Approach**

1. Income Approach

The income approach considers the present value of cash flows that an asset is expected to generate in the future.

While valuing customer-related intangible assets, the income approach is most widely used. There are many different methods within the income approach, which are discussed below, along with how they can be used for valuing customer-related intangible assets.

a. Multi-Period Excess Earnings Method (MPEEM)

Under this method, the value of the intangible asset is the estimation of future cash flows that it might generate discounted to the present value.

This method is used when the intangible asset to be valued is the primary intangible asset of the business. If so, then the primary intangible asset is valued using the MPEEM method while other intangibles are valued using other methods.

For example, while valuing a tech-based company with intangibles in the form of Intellectual Property Rights and a large user base, customer-related intangibles are measured using the MPEEM method, and Intellectual Property Rights are measured using other methods.

MPEEM is the most widely used method to value customer-related intangible assets. In this method, the value is considered to be the present value of the cash flows attributable to customer relationships adjusted with the attrition rate of customers and cash flows pertaining to contributory assets (assets that contribute to the cash flows of the customer-related intangible asset such as working capital, fixed assets, assembled workforce, and any other intangible assets).

Over The Top (OTT) platforms such as Netflix, Amazon Prime, and Hulu Plus provide streaming services that deliver content over the internet. They offer users several programs licenses as well as original programs. These companies purchase movie and show rights for their library of content. They majorly have two types of intangible assets - licenses and the subscriber base. Considering the fact that these platforms earn the majority of their revenue from subscription fees, these customer-related intangibles are valued using MPEE.

Example

Let's assume Company X is a service provider for generic IT solutions. Company X relies on its well-established and loyal customer base for a majority of its revenue. In such a case, the primary value driver for Company X will be its customer relationships. Without its customers, Company X would have been just another service provider for generic IT solutions with lower margins. The value of Company X's customer relationships can be best valued using MPEEM as most of the excess profits that Company X generates are on account of stability of revenue and lower customer acquisition costs accruing from Company X's customer relationships.

b. Distributor Method

This method is used when the primary business driver is a strong and unique intellectual property, such as a brand or technology, and customer relationships, though relevant and material, have limited relevance as compared to the primary business driver. As the primary business driver generates its own demand, and customers avail the service or product due to this demand rather than a pre-existing relationship. In such a situation, the relationship with customers is based on the business' ability to provide the desired product/service in a timely and efficient manner. Therefore, in the absence of the primary business driver, the business's relationship with its customer is equivalent to a distributor's relationships with its customers - it is contingent upon providing a desired product/service in a timely manner.

If MPEEM is used to value customer relationships, it may provide a value that is inconsistent with a qualitative assessment of the underlying assets and value drivers. To overcome this inconsistency, the company-specific margin is replaced with a market-based margin of a distributor company, as a reasonable market proxy, in an MPEEM. The more unique or proprietary the primary business driver of the product/service, the lower the margin typically earned by the distributor and the lower the value contributed by the customer relationship function and vice versa. Therefore, the Distributor method provides a robust valuation conclusion.

c. With and Without Method

This method is used when customer-related intangible assets are not the primary asset of the business. In this method, the business is valued using two scenarios. In the first scenario - With - the business is valued with the customer-related intangible assets, and in the second scenario - Without - the business is valued without considering the customer-related intangible assets. The difference between both scenarios provides the value of the customer-related intangible assets.

This method is used to value customer-related intangible assets when they are not the major source of revenue, whereas MPEEM is used when the intangibles are the major source of revenue.

In this method, future cash flows are also projected, which are discounted to find the present value under both scenarios. The discounted rate to be used in both methods must be the same. The difference between the present value of cash flows under both scenarios is considered to be the value of the customer-related intangible assets.

Example

Suppose Company A operates in the Fast Moving Consumer Goods (FMCG) industry and sells products through regular channels of distributors and retailers who buy the company's products primarily due to the trust and quality associated with Company A's brands/trademarks. In such a case, though Company A would have a relationship with customers, the relationship is primarily reliant on its brands/trademarks to market its products. Therefore, while valuing customer-related intangibles for Company A, it would be unwise to assign the entire Multi-Period Excess Earnings to customer-related intangibles. Instead, it would be more prudent to use the margins and risk profile of the distribution companies as a market proxy to the company's margins/risk profile while computing the value of customer-related intangibles. Thereafter, the value of customer relationship is used as an input to value Company A's brands/ trademarks using MPEEM.

Example

Let's assume that Company A runs an established business with a prominent Tradename and a loyal customer base. Company A is in the process of being sold to Company B. During the course of the transaction, it comes to light that a majority of the customers of Company A are unlikely to continue to be customers of the company post its acquisition by Company B. In such a scenario, even though Company B considers Company A's Tradename as the primary value driver, Company B would still want to revise its bid for the Company A (i.e. the value of Company A will be different if its loyal customer base continues to be loyal even after the acquisition versus if they do not). The With and Without method can possibly be used to identify the amount by which Company B should revise its bid.

2. Market Approach

While valuing intangible assets using a market approach, there has to be an active market for the intangible and sufficient information about the transactions. This method uses prices and other relevant information generated by market transactions involving intangible assets.

Using a market approach for valuing customer-related intangible assets is quite difficult, and it may seem untenable to obtain sufficient transaction data. However, it can be used for benchmarking the value of the intangible.

In 2012, Facebook acquired Instagram for USD 1 billion[1]. This acquisition gave Facebook access to the 30 million active users of Instagram. Therefore, we can benchmark the per user acquisition cost at 33.33 USD (USD 1 billion/30 million users). This benchmark can be used while valuing similar deals after adjusting for various factors. In 2014, when Facebook acquired WhatsApp, Facebook paid USD 19 billion to acquire 450 million users of WhatsApp, equivalent to USD 42 per user[2].

Example

Suppose Facebook was to acquire Telegram and expand its reach. Facebook might value Telegram for USD 30 - 50 per user after considering the deal with WhatsApp, which can be used to benchmark its deal with Telegram.

3. Cost Method

The cost method is based on the principle that an investor will pay no more for an asset than the cost to replace it with an identical or similar asset. Valuation of an intangible asset using the cost approach is based on the principle rule of substitution – the amount that will be required to create a new similar intangible asset.

This method can be used to value customer-related intangible assets when they are not the primary asset and can be recreated in a short period of time.

They can be used for early-stage companies where they are unable to forecast revenue with reasonable certainty or when other approaches are difficult or not possible.

Example

Hypothetically, Company A and Company B operate in the same business line and make marketing expenses of USD 500 and USD 1000 respectively. They achieve the same level of operating profit of USD 3000 and reached the same customer base of 250. Then the acquisition cost per customer for Company A and B would be USD 2 and USD 4 respectively (marketing expense/customer base). If Company A were to acquire Company B, it would value the customer-related intangible of Company B at USD 500 (customer base of Company B multiplied by the per customer acquisition cost of Company A).

The Multi-Period Excess Earnings Method (MPEEM) is the most appropriate method while valuing customer-related intangible assets when customer-related intangibles is the primary value driver of a business. Whereas when customer-related intangibles are a secondary value driver, the preferred method to value customer-related intangibles is the Distributor method. For the Market Approach method, past transactions involving customer-related intangibles is preferably used as an independent benchmark.

1. *https://money.cnn.com/2012/04/09/technology/facebook_acquires_instagram/index.htm*
2. *https://timesofindia.indiatimes.com/itslideshowviewall/30740473.cms?from=mdr#:~:text=Several%20analysts%20had%20termed%20Instagram,per%20user%20with%20the%20deal.&text=The%20WhatsApp%20acquisition%20is%20one,or%20Apple%20have%20ever%20done.*

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