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BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

Letters From the SEC
Business Combinations Edition

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Executive Summary

- The SEC's comment letters on public company filings give insight into what factors should be considered when discussing business combinations.
- We discuss and comment upon four examples covering customer relationships, tradenames, contingent consideration, and bargain purchases.
- An understanding of how the SEC has approached these issues in the past will better prepare companies and their advisors for the level of scrutiny that often accompanies the accounting for business combinations.

Introduction

ASC 805 provides guidance on the accounting and reporting for business combinations. Generally, an acquirer, whether public or private, must allocate the consideration paid for the business across tangible and identifiable intangible assets, with any residual purchase price over the fair value of such assets attributed to goodwill. The Division of Corporation Finance (the "Division") of the U.S. Securities and Exchange Commission ("SEC") ensures that publicly-traded firms disclose material information, such as those relevant to certain business combinations, to investors through its review of certain public filings, including Form 10-K, Form 10-Q, proxy materials, and other filings.

Upon completion of its review of the aforementioned filings, the Division may issue "comment" letters to the public filers. Comment letters set forth staff positions and do not constitute an official expression of the SEC's views. Comment letters may request that a company (i) provide additional supplemental information so the Division staff can better understand the company's disclosure; (ii) revise disclosure in a document on file with the SEC; (iii) provide additional disclosure in a document on file with the SEC; or (iv) provide additional or different disclosure in a future filing with the SEC. Several rounds of comment letters and response letters between the Division and the filer or the filer's legal counsel may occur until the issues are resolved.

Comment letters are frequently issued in relation to business combinations. Comment letters and response letters are public information and can provide unique insight into both qualitative and quantitative factors that should be considered in determining the fair value of intangible assets when performing a purchase price allocation. The following is a sample of specific issues the Division has commented upon in recent years concerning business combinations and individual intangible assets.

Customer Relationship Valuation and Useful Life

On September 1, 2021, TD SYNNEX Corporation ("TD SYNNEX") purchased all of the outstanding shares of common stock of the parent entity of Tech Data Corporation ("Tech Data") for approximately $7.2 billion. Identifiable intangible assets included customer relationships with an allocated fair value of $3.86 billion. The Division reviewed TD SYNNEX's Form 10-K filed on January 28, 2022 for fiscal year 2021, noting the following about the Tech Data customer relationships: (**Click here to see full comments and responses)**

> "We note you recorded $3.86 billion as the fair value of customer relationships with a weighted average useful life of 14 years. Please tell us how you evaluated the guidance in ASC 350-30-35-3 in determining the useful life, including explaining the characteristics of the customer list that support this assigned life, and all other pertinent factors considered in your analysis."

TD SYNNEX responded as follows:

> "The Company respectfully submits that in measuring the fair value of the customer relationships acquired as part of the acquisition of Tech Data, we engaged an independent internationally-recognized firm that valued the customer relationships using the multi-period excess earnings method, a variation of the income approach. Under the multi-period excess earnings method, the remaining useful life is an output rather than an input. Therefore, the Company considered guidance under ASC 350-30-35-3 which states that if an income approach is used to measure the fair value of an intangible asset, in determining the useful life of the intangible asset for amortization purposes, an entity shall consider the period of expected cash flows used to measure the fair value of the intangible asset adjusted as appropriate for the entity-specific factors in this paragraph."

In most cases, customer relationships acquired in a business combination are valued using the multi-period excess earnings method, or MPEEM. The various assumptions and mechanics of the MPEEM are beyond the scope of this article. The lesson here, though, is that choosing the correct methodology for valuing an intangible asset is just the first step. The Company's response continued:

> "The Company advises the Staff that Tech Data as a global IT distributor, purchased and resold technology products to an active customer base of more than 100,000 resellers, system integrators, and retailers. Tech Data predominantly sold products to its customers on an individual purchase order and transactional basis, rather than pursuant to long-term contracts. Although long-term contracts are not in place, customer relationships are strong within the IT distribution industry with relatively low customer attrition rates. In measuring the fair value of customer relationships, the Company established that approximately 90% of the present value of expected cash flows used to measure the customer relationships intangible asset were generated over a period of 12 to 15 years. The period over which 90% of the present value of expected cash flows were generated varied slightly within this range between the three geographic regions in which Tech Data operated (Americas, Europe and Asia Pacific). The customer attrition rates applied in valuing the customer relationships were based on the historical experience of Tech Data and the expected attrition in the customer base within each of the geographic regions. Based on the foregoing factors, we believe a weighted average useful life of 14 years is appropriate."

TD SYNNEX's response emphasizes a quantitative approach as it relates to the characteristics of cash flows from customer relationships that support the 14-year weighted average useful life as requested by the Division.

Trademark/Trade Name

On December 30, 2017, Live Ventures Incorporated ("Live Ventures") acquired 100% of ApplianceSmart Inc. and ApplianceSmart Contracting, Inc. ("ApplianceSmart") for $6.5 million. The intangible assets included a trade name, which was assigned a fair value of $2.0 million. The Division reviewed Live Ventures' Form 10-K filed on December 27, 2018 for the fiscal year ended September 30, 2018, noting the following about the ApplianceSmart trade name: (**Click here to see full comments and responses)**

> "Given the financial deterioration of ApplianceSmart prior to purchase, please tell us in more detail how you determined the trade names acquired were worth over $2 million."

Companies that are contemplating an acquisition and preparing the related disclosures would do well to note the line of questioning from the Division in this example, particularly the emphasis on methodology.

Live Ventures responded as follows:

> "…As part of determining the value of the assets acquired, ApplianceSmart engaged an outside company, Gordon Brothers, to fair value the acquired assets…In determining the fair value of the ApplianceSmart trade name, Gordon Brothers performed a quantitative valuation using the relief from royalty methodology of the income approach…This fair value measurement methodology is premised on the assumption that an owner/operator of a company would be compelled to pay the rightful owner of the intangible asset (such as a trade name) if the owner/operator did not have the legal right to utilize the subject intellectual property. Since ownership of a trade name relieves a company from making such payments, the financial performance of the firm is enhanced to the extent that these royalty payments are avoided."
>
> Gordon Brothers conducted the following analysis to estimate the fair royalty rate and the fair value of the ApplianceSmart trade name, which included:
>
> - Discussing the use of the trade name with Management;
> - Searching for royalty rates in the market comparable to the Company;
> - Estimating the royalty rate for the subject trade name;
> - Estimating the respective required rates of return;
> - Applying the relief from royalty rate method to provide an indication of Fair Value; and
> - Applying an amortization tax shield benefit related to the potential tax savings from amortization of the value.

> In addition to the above quantitative calculation, Gordon Brothers gave qualitative consideration to the following:
>
> - The name recognition of ApplianceSmart's trade name;
> - The products provided by the Company versus the selected market transactions;
> - The market served and the importance of trade name within the industry;
> - The length of existence of the trade name; and
> - ApplianceSmart management's perception and evaluation of the recognition of the trade name in the industry"

Pretty thorough response, right? Not for the Division, which came back in another comment letter (more than one year later!) asking for more explanation from Live Ventures. Remember - the original question above asks for "more detail."

> "We note your response to comment 3. Please provide more detail regarding the royalty rate for the subject trade name and respective required rates of return used in the relief from royalty calculation. In addition to quantifying the inputs, please tell us how these inputs were determined, if a range of inputs were considered, and the magnitude of the impact on the trade name value if other inputs within the range, if any, had been used."

Concerning the selection of the royalty rate used, the Company responded:

> "In evaluating the ApplianceSmart trade name, third-party royalty rates are used as a guide to establish a range of possible value. Gordon Brothers utilized the ktMINE Database to research third-party royalty rates for similar trade names, namely, storefront brands, utilized within the industry for household appliance stores. Based on their research, five comparable licensing agreements for similar trade names were found that support royalty rates yielding a median range from a low of 0.35% to a high of 1.1%, with a median range around 0.7%...After consideration of the above qualitative factors and the market-derived royalty rates, Gordon Brothers determined a 0.5% royalty rate to be reasonable in the valuation of ApplianceSmart's trade name.
>
> The economic value of this trade name is expressed as the present value of the expected after-tax royalty savings. Accordingly, the royalty earnings can be calculated by applying the royalty rate to the estimated sales. The royalty savings were applied to the total sales as all sales are generated under the subject trade name.

> The royalty savings were further adjusted for taxes and then discounted to present value using a discount rate that reflects the risks inherent in intangible assets such as the subject. This discount rate reflects the additional risk in an investment in intangible assets versus the business as a whole.
>
> In addition, Gordon Brothers added an amount representing the net present value of the tax savings resulting from the amortization of the value of the trade name over a 15-year period to the net present value of the after-tax royalty savings to yield an indication of Fair Value for the trade name of $2.0M.
>
> Gordon Brothers has estimated a 20-year remaining useful life for trade name based on the nature of the industry, the length of time that the Company has been in business, discussion with Management, and the relative strength of the trade name in the marketplace…"

Concerning the selection of the discount rate used, the Company responded:

> "Gordon Brothers made a determination of required rates of return based on the following assessments and assumptions.
>
> Assets within a business enterprise have different risk, liquidity, and return characteristics. The rate of return on any particular asset is typically commensurate with its risk, with the discount rate reflecting the risk associated with the income attributable to the asset…Intangible assets in any valuation depend on the facts and circumstances of each individual valuation. Returns on individual assets are selected based upon a number of factors, including the current costs of funds, the type of asset and its liquidity, whether the asset is likely to be accepted as collateral for debt-financing purposes, whether it is a special-purpose asset or has a broader use, and discussions with asset-based lenders on current trends. In general, higher liquidity of an asset leads to increased marketability and greater acceptance as collateral, and less equity is required to finance the asset. Therefore, a more highly liquid asset will have a lower required rate of return."

Ultimately, Gordon Brothers selected a discount rate of 18.6% for use in the relief from royalty method. We are not aware of any further communication from the Division, so presumably the additional detailed response was sufficient.

Contingent Consideration

On December 31, 2020, NeuroBo Pharmaceuticals ("NeuroBo") acquired ANA Therapeutics, Inc. ("ANA"). The ultimate purchase consideration included contingent consideration related to the achievement of certain milestone events. The Division reviewed NeuroBo's Amendment No. 1 to Preliminary Proxy Statement on Schedule 14A, filed March 2, 2021, stating: **(Click here to see full comments and responses)**

> "We note your disclosure on page 6 that your preliminary estimate of the fair value of the contingent consideration was approximately $4.76 million. We also note from your response that you determined that the likelihood of payment of the contingent consideration was remote and that you have excluded the contingent consideration from total purchase consideration in your analysis. Please describe to us how the fair value was determined, including how the likelihood of payment factored into the determined fair value."

NeuroBo's legal counsel responded as follows:

> "In response to the Staff's comment, we note that the third-party valuation was subsequently revised on April 1, 2021. The original valuation, commissioned in order to satisfy Section 3.6 of the Merger Agreement for purposes of ensuring compliance with the requirements for the tax-free nature of the exchange, valued only the contingent consideration that could potentially be triggered by the Milestone Payments. The valuation was subsequently revised in part to fully include the potential royalty payments to the ANA Equityholders as well as potential royalty payments pursuant to the YourChoice Therapeutics, Inc. License Agreement that was assumed in connection with the ANA Acquisition, which, as disclosed in the Company's Form 8-K/A filed with the Commission on March 1, 2021, includes certain potential single-digit royalty payments and milestone payments in the aggregate amount of $19.5 million. As a result, the final fair value of the contingent consideration was ultimately estimated at $18.3 million. We have revised page 10 of Amendment No. 2 accordingly.
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> …The fair value of the contingent consideration in the third-party valuation was arrived at as follows:
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> - The Approval Milestone Payment, which would become payable upon FDA approval of the Company's Niclosamide Product (as defined in the Merger Agreement), was estimated based on management's most likely estimate of FDA approval (assumed approval milestone date of June 1, 2022 with a contractual payment date 60 days thereafter of August 1, 2022), a discount rate that is commensurate with risk of achievement and incorporation of counterparty risk, and clinical trial approval data based on "Clinical Development Success Rates 2006-2015," BIO, Biomedtracker, Amplion.
>
> - The Sales Milestone Payments and the Royalty Payments were estimated using a Monte Carlo simulation involving a quarterly revenue forecast curve developed based on an 8-year revenue forecast provided by management, and were risk-adjusted using a discount rate that is commensurate with risk of achievement and incorporation of counterparty risk.
>
> This methodology resulted in a single-step contingent consideration value of $5.07 million, with a mean sensitivity analysis value of $18.3 million."

Contingent consideration, also referred to as an earnout, is often valued using Monte Carlo Simulation as referred to in the response. Although other methods are acceptable, Monte Carlo Simulation is one of the most common, if not the most common, method. While not disclosed in the Company's response, a Monte Carlo Simulation will typically consist of 100,000 or more trials based on certain parameters under which an event is likely to occur (in this case, the milestone events referred to above). The $18.3 million fair value conclusion is likely to be the average indication based on a similar number of trials.

Bargain Purchase

Navios Maritime Acquisition Corporation ("Navios Acquisition") merged with Navios Maritime Midstream Partners L.P. ("Navios Midstream") on December 13, 2018, acquiring all of the outstanding publicly held common units of Navios Midstream. The Division reviewed Navios Acquisition's Form 20-F for the Fiscal Year Ended December 31, 2018, stating: **(Click here to see full comments and responses)**

> "We note that in accounting for the acquisition of the remaining interest of Navios Midstream, you recorded a bargain purchase gain. Please tell us and revise to disclose the reasons why the transaction resulted in a gain."

Navios Acquisition's legal counsel responded as follows:

> "The amounts included in this response are expressed in thousands of U.S. Dollars in order to conform with the disclosures contained in Note 3 of Navios Acquisition's Form 20-F. The excess of the fair value of the identifiable net assets acquired of $123,450 over the total purchase price consideration of $54,499, resulted in a bargain purchase gain in the amount of $68,951. During 2018, the publicly traded stock prices of US listed shipping companies were trading at discounts to their net asset value ("NAV"). This trading discount to NAV resulted in the recognition of a bargain purchase gain for Navios Acquisition. The purchase price and the number of shares to be issued at the closing of the acquisition was proposed in June 2018 by using a conversion rate of 0.42 of a Navios Acquisition share to one common unit of Navios Maritime Midstream Partners L.P. ("Navios Midstream"), which was based on the market share prices in June 2018, plus an implied 1% premium. The definitive agreement that validated the proposed conversion rate was signed in October 2018 between Navios Acquisition and Navios Midstream. The proposed conversion rate was accepted with no adjustments. Between the proposal date, the date of the signing of the definitive agreement and the date of closing, there was no adjustment made to the number of shares to be issued by Navios Acquisition for movement in the share price or the price of the net assets to be acquired."

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A bargain purchase may occur when the seller is motivated to sell quickly, and therefore, may not execute a formal competitive bid process or does not engage actively in negotiating with the purchaser. The parties in this example are related and may not have engaged in a typical arms-length transaction, resulting in a bargain purchase. Furthermore, the length of time between price negotiation and closing a transaction can lead to situations where the fair value of assets acquired exceeds purchase consideration. In our experience, bargain purchases are infrequent, so reviewers such as external auditors (and the SEC) expect a compelling rationale for why such gains are supportable.

Conclusion

As evidenced by the questions discussed above, the SEC is certainly paying attention to business combinations disclosures. This has always been the case for public entities. But even for private companies that aspire to become public one day or desire to prepare quality audited financial statements, the need for supportable and defensible fair value measurements is crucial. Our hope is that the questions and responses highlighted above will better prepare you for the level of scrutiny that often accompanies the accounting for business combinations – and may help you avoid being on the receiving end of these types of comment letters.

Mercer Capital has been helping public and private companies with valuation services around business combinations for decades. Please contact one of our professionals today with any questions or to discuss your needs in confidence.

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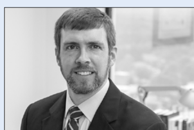

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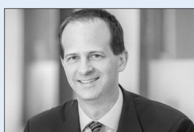

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