Non-Compete Agreements

Valuation Issues in GAAP and Tax Engagements

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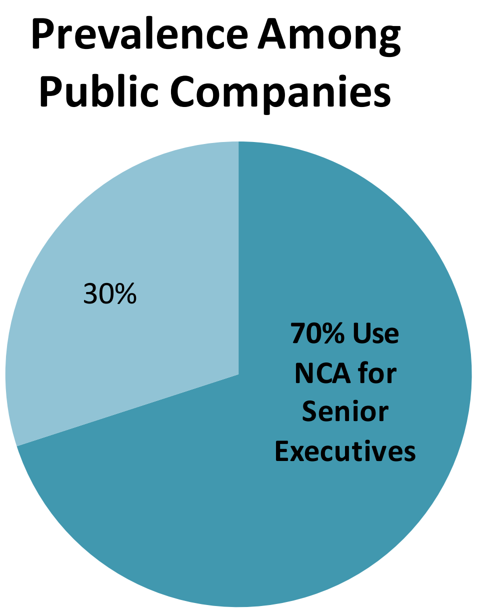
Presentation Overview

- Overview and Background
- Valuation Guidance
- Valuation Approaches
- Examples
- Other Issues in NCA Valuation
- Additional References

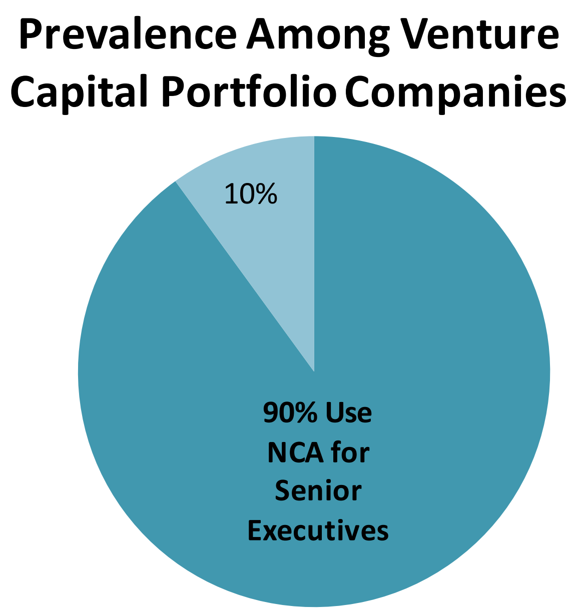
NCAs Pop Up in All Kinds of Situations

- Acquisitions
  - Often required for the seller
- Consulting/Employment Agreements
  - Protection for employers
- Divorce
  - Generally not considered a marital asset
- Tax
  - Section 280G (Golden Parachute Payments)

They are More Prevalent at Small Companies



Source: Garmaise (2009). Includes S&P 500, Mid-Cap 400, and Small-Cap 600



Source: Kaplan and Stromberg (2003)

So Why Do Non-Competes Have Value?

» (Theoretically) NCAs capture personal goodwill as corporate goodwill

» Reduce risk associated with business acquisitions

- Make sure you “get what you bought”
- Protect revenue / profitability of acquisition

» Encourage employees to remain with their employers

- Although this can backfire on the hiring side

» Minimize impact of key employee losses

Non-Competes Don’t Always Have Value

- Immaterial Impact
  - If the employee would not be expected to cause “economic damage”
- Issues with enforceability
- Company or industry-specific factors that render the NCA not meaningful
  - Asset intensive businesses may be less susceptible to actions of former employees

Valuation Isn’t Always Clear-Cut

- Non-compete valuation is one of the more subjective areas of valuation practice
  - Incorporates many elements of a business valuation
    - Requires projection of impact of competition (revenue and margins)
  - Adds potentially subjective estimates of
    - Impact of competition (amount and duration)
    - Likelihood of competition (ability and willingness)
- Covered party(s) may be an individual, group of individuals, or a business entity

Enforceability of NCA is Often Debatable

- Enforceability varies state-by-state
- Absent evidence to the contrary, valuation specialists generally assume that NCA are enforceable
- Even if enforceability is questionable, threat of an action for breach of a NCA may reduce an individual's propensity to compete

Bonus: Valuation for Section 280G (taxes)

- 280G provides for penalties on excess parachute payments to executives of target companies in mergers & acquisitions
- Amounts allocated to NCA may be characterized as reasonable compensation after a change-in-control . May be exempt from 280G excise taxes
- Value of NCA typically limited to the lesser of:
  - Amount of economic loss if individual were to compete, or
  - Level of reasonable compensation individual could have earned during the restricted period
- Substantiating NCA value can lower individual’s and/or corporation’s taxes

Valuation Guidance

Valuation Guidance

- Financial Reporting Guidance
  - FASB Statements, other
- Tax Reporting Guidance
  - IRS Guidance
  - Tax court cases
- Other non-authoritative
  - Books, articles, best practices

There is Some GAAP Guidance

- ASC 805 recognizes NCA as marketing-related intangible assets
- ASC 820 and ASC 350 provide accounting principles and guidance related to fair value matters, they do not discuss NCA
- AICPA Practice Guides
  - No direct discussion of NCA
- TAF Monograph on Contributory Assets
  - Brief discussion of NCA as a contributory asset

The PCAOB has Grown Interested

» From PCAOB Inspection reports

“…There was no evidence in the audit documentation, and no persuasive other evidence that the firm had tested the reasonableness and consistency of certain of the significant assumptions management had used to value the non compete agreement.”

“. . . The apparent inconsistency between the economic life of the non compete agreement for valuation purposes and that for amortization purposes.”

Earliest Guidance Comes from IRS

- Revenue Ruling 77-403 (1977-2 C.B. 302)
  - Whether or not a payment made for an NCA in connection with the purchase of real property was part of the cost of property or the cost of a separate asset
  - The relevant factors include:
    - Whether, in the absence of the NCA, the covenantor would **desire** to compete
    - The **ability** of the covenantor to compete effectively with the covenantee in the activity in question
    - The **feasibility**, in view of the activity and market in question, of effective competition by the covenantor within the time and area specified in the covenant

And, of course, the Tax Court

- Courts often cite multi-factor “economic reality tests” when considering the value of an NCA
- Some of the factors are used in conjunction with the valuation opinions of expert witnesses, but not always
- Court decisions are subjective and do not contain clear-cut methods for valuing NCAs
- Nevertheless, the “economic reality tests” outlined in various cases can offer insights

Tax Court on NCA: *Beaver Bolt v. Commissioner* (TCM 1995-549)

» Nine factor economic reality test for NCA which considers:

1. The Seller's (covenanter's) ability to compete
2. Seller's intent to compete
3. Seller's economic resources
4. The potential damage to the buyer posed by the seller's competition
5. Seller's business expertise in the industry

Tax Court on NCA:
Beaver Bolt v. Commissioner (TCM 1995-549)

» Nine factor economic reality test (continued)

6. Seller’s contacts and relationships with customers, suppliers, and other business contacts
7. Buyer’s interest in eliminating competition
8. Duration and geographic scope of the covenant
9. Seller’s intent to reside in the same geographic area

Tax Court Guidance Part 2:
Thompson v. Commissioner (TCM 1997-287)

» Cites most of the Beaver Bolt factors, plus five more:

- The **age and health** of the grantor
- The **enforceability** of the covenant under State law
- Whether payments for the covenant are pro rata to the grantor's stock ownership in the company being sold (relates to economic substance)
- Whether the payments under the covenant cease upon breach of the covenant or upon death of the grantor
- The **existence of active negotiations over the terms and value** of the covenant (other than tax-motivated)

NCA: Valuation Approaches (Cost, Market, Income)

You’ll Rarely Use the Cost Approach

- What if an NCA has a stated “cost”?
  - NCAs sometimes include a stated payment or series of payments to the subject individual
  - Stated or contractual payments are often just a nominal sum paid “to get the deal done” with little relevance to the actual economic value of a non compete covenant. May have been included for tax purposes
- What if there is <u>no</u> stated “cost”?
  - More common situation when no explicit consideration is paid for signing an NCA. The cost approach is infrequently used to value NCAs

And You’ll Never Use the Market Approach

- Use of the market approach to value NCAs is rare
- Limitations include:
  - Bundled transactions: NCAs are often sold bundled with other business assets, and it can be difficult to assess the value of a single component in a complex transaction
  - No organized data on the “sale” of NCAs
  - Limited disclosure where transaction information is available
  - Comparability Issues – Even if market data was available, NCAs are unique to a particular buyer and seller

Which Leaves Us With the Income Approach - WWM

- The most common method for valuing an NCA is the With/Without method (“WWM”).

- This method is also referred to as:
  - Income Increment / Cost Decrement Method
  - Comparative Business Valuation Method
  - The Differential Value Method

Why the WWM?

- The value of an NCA is typically derived from the avoidance of loss as a result of:
  - Reduction in revenue
  - Increase in expenses
  - Deferral of development
  - Change in working capital needs
  - Anything that could otherwise reduce the cash flows of the business

“With” Matters

» The analyst must be familiar with the “base case” valuation of the business

» Presumably, the “base case” financial projections assume that a noncompetition agreement is in place (the “With” scenario)

- The projections used should be normalized (i.e. reflect market participant assumptions)
- The best approach is to be consistent with the market participant based projections used in the IRR calculation (if valuing an NCA in the context of ASC 805)

WWM: A Graphic

OBJECTIVE
(AUDITABLE)

Impact on Cash Flow

- Δ Revenue :: Nature of Customer Relationships
- x Operating Leverage :: Margin Impact
- x Impact of Timing :: Duration, Intensity

Ability to Compete

- Nature of Industry :: (Asset ↔ Labor)
- Business Model :: (Branded ↔ Relational)
- Position in Company :: Proximity to clients/employees
- Personal Factors :: Skills, Education, Experience, Aptitude

Willingness to Compete

- Age :: Young & Aspiring or Ready to Retire?
- Health :: Able to go after the business?
- Wealth :: Too rich to care?
- Personality :: Newly content or still driven?

SUBJECTIVE
(NOT AUDITABLE)

WWM: Start by Estimating Impact on Revenue

- Δ Revenue: Nature of Customer Relationships
  - P x Q
  - Loss of existing customers or new customers?
  - Impact on selling prices?
  - Tie to customer relationship valuation?

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WWM: Then Think About Margins

- Operating Leverage: Margin Impact
  - Decreased overhead absorption due to lower volume?
  - Higher marketing expenses?
  - Increased salary expenses to keep employees from defecting to new competitor?
  - More R&D required to stay competitive?

WWM: Don’t Forget to Consider Timing

» Impact of Timing: Duration, Intensity

- If competition began immediately, how long until it would affect the existing business?
- What are the start-up costs ($ and time) to competition?
- When would competition begin?
- Are current customers on long-term contracts?
- Would the duration/intensity of competition be reduced by the retaliatory impact of the existing company?

Industry Knowledge Matters

- Nature of Industry: (Asset ↔ Labor)
  - Is this a commodity business or a people business?
- Business Model: (Branded ↔ Relational)
  - How does the subject firm sell to customers?
  - Can the individual really poach customers?

So Does the Position of the Individual

- Position in Company: Proximity to clients/employees
  - Are the client relationships really with the CEO or the salespeople?

- Personal Factors
  - Skills, Education, Experience, Aptitude
  - Did the CEO build the business the first time around?
  - Could he do it again?

Is the Covenanted Person *Willing* to Compete?

- Most difficult (and subjective) input to quantify
- Willingness is a function of:
  - **Age**: Young & Aspiring or Ready to Retire?
  - **Health**: Able to go after the business?
  - **Wealth**: Too rich to care?
  - **Personality**: Newly content or still driven?
  - Other case-specific factors (**of course**)…

Then, You *Value* the Change in Cash Flow

» What discount rate should be used to value NCA?
  - **Caution: No clear guidance on this issue**
  - Many practitioners favor use of the WACC since the WWM generally resembles projections used in a general valuation of the target business
  - Others use the WACC in the base case, and a higher discount rate in the competition scenario to recognize higher risk absent an NCA

» **Uncertainty with likelihood of competition may be best captured in the cash flows and a probability factor**, and not an adjustment to the discount rate

WWM – Example 1

- Single scenario model
- Impact on Cash Flow
  - Negative impact on revenue via % of sales
  - Operating margin (reduced by 2.0% during competition)
- Ability and Willingness to Compete
  - Modeled as a single percentage likelihood of competition

EXAMPLE 1 **WWM: Discrete projection period and probability assumption at end**

(in thousands)

	WITH AGREEMENT, BASE CASE					WITHOUT AGREEMENT, COMPETITION				
	LTM	Year 1	Year 2	Year 3	Year 4	LTM	Year 1	Year 2	Year 3	Year 4
Negative Impact of Competition		*0.0%*	*0.0%*	*0.0%*	*0.0%*		*-10.0%*	*-10.0%*	*-5.0%*	*0.0%*
Sales	$10,000	$10,500	$11,025	$11,576	$12,155	$10,000	$9,450	$9,923	$10,997	$12,155
x Operating Margin	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	8.0%	8.0%	8.0%	8.0%
Operating Income	$1,000	$1,050	$1,103	$1,158	$1,216	$1,000	$756	$794	$880	$972
Income Taxes at 40.0%	(400)	(420)	(441)	(463)	(486)	(400)	(302)	(318)	(352)	(389)
Net Income	600	630	662	695	729	600	454	476	528	583
+ Deprec.	100	105	110	116	122	100	95	99	110	122
- CapEx	(100)	(105)	(110)	(116)	(122)	(100)	(95)	(99)	(110)	(122)
+/- Change in W/C	(50)	(53)	(55)	(58)	(61)	(50)	(47)	(50)	(55)	(61)
Net Cash Flow	**$550**	**$578**	**$606**	**$637**	**$669**	**$550**	**$406**	**$427**	**$473**	**$523**
Discounting Periods		0.5	1.5	2.5	3.5		0.5	1.5	2.5	3.5
Present Value Factors	**15.0%**	0.9325	0.8109	0.7051	0.6131	**15.0%**	0.9325	0.8109	0.7051	0.6131
PV of Net Cash Flow		**$539**	**$492**	**$449**	**$410**		**$379**	**$346**	**$333**	**$320**

PV of Discrete Cash Flow - WITH	$1,889	
PV of Discrete Cash Flow - WITHOUT	1,379	
PV of Cash Flow Protected	**$510**	
x Probability Factor	30.0%	*<> Based on specific facts and circumstances*
Value of Non-Compete Agreement	**$153**	
Plus: Tax Amortization Benefit	31	*<> 15 yrs, 40% tax rate*
Indicated Fair Value	**$184**	

WWM – Example 2

- Multi-scenario model
- Assumes competition could start in different periods with differing impacts on cash flow
- Each scenario probability-weighted at the end of the analysis
- Additional precision = additional accuracy?
  - Don’t count on it

WWM – Example 2

EXAMPLE 2 **WWM: Multi-Scenario Approach assuming competition starts in different years**

(in thousands)

	WITH NCA - BASE CASE				
	LTM	**Year 1**	**Year 2**	**Year 3**	**Year 4**
Negative Impact of Competition		*0.0%*	*0.0%*	*0.0%*	*0.0%*
Total Projected Revenue (5% growth)	$10,000	$10,500	$11,025	$11,576	$12,155
Less: Impact of competition	0	0	0	0	0
Adjusted Revenue	$10,000	$10,500	$11,025	$11,576	$12,155
x Operating Margin	10.0%	10.0%	10.0%	10.0%	10.0%
Operating Income	$1,000	$1,050	$1,103	$1,158	$1,216
Income Taxes at 40.0%	(400)	(420)	(441)	(463)	(486)
Net Income	$600	$630	$662	$695	$729
+ Depreciation	100	105	110	116	122
- Capital Expenditures	(100)	(105)	(110)	(116)	(122)
+/- Change in Working Capital	(50)	(53)	(55)	(58)	(61)
Net Cash Flow	**$550**	**$578**	**$606**	**$637**	**$669**
Discounting Periods		0.5	1.5	2.5	3.5
Present Value Factors	**15.0%**	0.9325	0.8109	0.7051	0.6131
PV of Net Cash Flow		**$539**	**$492**	**$449**	**$410**
PV of Net Cash Flow - Base Case		**$1,889**			

	WITHOUT NCA - COMPETITION BEGINS IN YR. 1				
	LTM	**Year 1**	**Year 2**	**Year 3**	**Year 4**
Negative Impact of Competition		***-10.0%***	***-10.0%***	***-5.0%***	***0.0%***
Total Projected Revenue (5% growth)	$10,000	$10,500	$11,025	$11,576	$12,155
Less: Impact of competition	0	(1,050)	(1,103)	(579)	0
Adjusted Revenue	$10,000	$9,450	$9,923	$10,997	$12,155
x Operating Margin	10.0%	8.0%	8.0%	8.0%	8.0%
Operating Income	$1,000	$756	$794	$880	$972
Income Taxes at 40.0%	(400)	(302)	(318)	(352)	(389)
Net Income	$600	$454	$476	$528	$583
+ Depreciation	100	95	99	110	122
- Capital Expenditures	(100)	(95)	(99)	(110)	(122)
+/- Change in Working Capital	(50)	(47)	(50)	(55)	(61)
Net Cash Flow	**$550**	**$406**	**$427**	**$473**	**$523**
Discounting Periods		0.5	1.5	2.5	3.5
Present Value Factors	**15.0%**	0.9325	0.8109	0.7051	0.6131
PV of Net Cash Flow		**$379**	**$346**	**$333**	**$320**
PV Net Cash Flow - Comp Beg. Yr. 1				**$1,379**	

WWM – Example 2 (continued)

EXAMPLE 2 **WWM: Multi-Scenario Approach assuming competition starts in different years**

(in thousands)

	WITHOUT NCA - COMPETITION BEGINS IN YR. 2				
	LTM	**Year 1**	**Year 2**	**Year 3**	**Year 4**
Negative Impact of Competition		***0.0%***	***-10.0%***	***-5.0%***	***0.0%***
Total Projected Revenue (5% growth)	$10,000	$10,500	$11,025	$11,576	$12,155
Less: Impact of competition	0	0	(1,103)	(579)	0
Adjusted Revenue	$10,000	$10,500	$9,923	$10,997	$12,155
x Operating Margin	10.0%	10.0%	8.0%	8.0%	8.0%
Operating Income	$1,000	$1,050	$794	$880	$972
Income Taxes at 40.0%	(400)	(420)	(318)	(352)	(389)
Net Income	600	630	476	528	583
+ Depreciation	100	105	99	110	122
- Capital Expenditures	(100)	(105)	(99)	(110)	(122)
+/- Change in Working Capital	(50)	(53)	(50)	(55)	(61)
Net Cash Flow	**$550**	**$578**	**$427**	**$473**	**$523**
Discounting Periods		0.5	1.5	2.5	3.5
Present Value Factors	**15.0%**	0.9325	0.8109	0.7051	0.6131
PV of Net Cash Flow		**$539**	**$346**	**$333**	**$320**

PV of Net Cash Flow - Comp Beg. Yr. 2	**$1,538**

	WITHOUT NCA - COMPETITION BEGINS IN YR. 3				
	LTM	**Year 1**	**Year 2**	**Year 3**	**Year 4**
Negative Impact of Competition		***0.0%***	***0.0%***	***-5.0%***	***0.0%***
Total Projected Revenue (5% growth)	$10,000	$10,500	$11,025	$11,576	$12,155
Less: Impact of competition	0	0	0	(579)	0
Adjusted Revenue	$10,000	$10,500	$11,025	$10,997	$12,155
x Operating Margin	10.0%	10.0%	10.0%	8.0%	8.0%
Operating Income	$1,000	$1,050	$1,103	$880	$972
Income Taxes at 40.0%	(400)	(420)	(441)	(352)	(389)
Net Income	600	630	662	528	583
+ Depreciation	100	105	110	110	122
- Capital Expenditures	(100)	(105)	(110)	(110)	(122)
+/- Change in Working Capital	(50)	(53)	(55)	(55)	(61)
Net Cash Flow	**$550**	**$578**	**$606**	**$473**	**$523**
Discounting Periods		0.5	1.5	2.5	3.5
Present Value Factors	**15.0%**	0.9325	0.8109	0.7051	0.6131
PV of Net Cash Flow		**$539**	**$492**	**$333**	**$320**

PV of Net Cash Flow - Comp Beg. Yr. 3	**$1,684**

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WWM – Example 2 (continued)

EXAMPLE 2 **WWM: Multi-Scenario Approach assuming competition starts in different years**

(in thousands)

Multi-Scenario WWM Summary	**PV Cash Flows - WITH Agreement**	**PV Cash Flows - WITHOUT Agreement**	**PV of Lost Cash Flow**	**Probability of Competition**	**Weighted Value**
Scenario 1: No Competition (Base Case)	$1,889	$1,889	$0	60.0%	$0
Scenario 2: Competition Begins in Year 1	1,889	1,379	510	25.0%	128
Scenario 3: Competition Begins in Year 2	1,889	1,538	351	10.0%	35
Scenario 4: Competition Begins in Year 3	1,889	1,684	205	5.0%	10
		PV of Cash Flow Protected			**$173**
		Plus: Tax Amort. Benefit (1)			35
		Indicated Fair Value			**$208**

(1) 15 yrs, 40% tax rate, 15% discount rate

Other Issues in NCA Valuation

Conditional Probabilities

- Suppose a 3-year NCA and a 10% probability of competition in any given year. What is the probability that competition starts in a particular year, given that competition did not occur in the prior years?
  - In each year, there is a 10% chance of competition and a 90% chance of no competition
  - Conditional probabilities of competition:
    - Competition begins in Year 1: 10%
    - Competition begins in Year 2: 90% x 10% = 9.0%
    - Competition begins in Year 3: 90% x 90% x 10% = 8.1%
    - Total conditional probability = 27.1% (72.9% probability of no competition)

Impact of Competition Beyond Stated Term

- Suppose a 3-year NCA. What if “damage” from competition might be experienced beyond Year 3? Should we:
  - Assume the cash flows return to base case in Year 4 because that’s the term of the NCA?
  - Project lower cash flows continuing beyond Year 3, including different terminal values for “With” and “Without”?
  - Should damage follow life of a <u>customer</u> rather than life of the <u>agreement</u>?

Overlap Between Executives?

- Suppose there are NCA with all 5 senior managers. The NCA prohibits solicitation of customers and employees. Should the analyst consider overlap?
  - What if the managers solicit the same customers/ employees?
  - Value each NCA <u>independent</u> of the others or as a group?
  - Should “value” of a NCA reflect perspective of the individual or the company? Is it different for GAAP vs. Tax?

Closing Thoughts

- For such a frequently encountered asset, surprisingly little authoritative valuation guidance
- FV or FMV, no difference in approach
- Balance the inputs
  - Objective and auditable
  - Subjective and (less) auditable
- Consideration of NCA value in the context of a market participant

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Additional References

- Training Courses
  - ASA BV302: Special Topics in the Valuation of Intangible Assets
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