Accounting for business combination: VALUING THE UNSEEN...

A study of purchase price allocation in India

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Foreword

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We are proud to present the third edition of our Purchase Price Allocation study.

Mergers & acquisitions have declined during the year ending Mar 2021 due to imposition of lockdown as a result of COVID-19. Nonetheless, M&A activity has remained a growth or survival strategy for many companies, particularly once economic stability and market confidence was restored.

Ind AS 103 Business Combinations ("Ind AS 103") transforms the way companies plan and execute their acquisition strategies. The standard applies to most of the business combinations, including amalgamations and acquisitions. The change in accounting for business combinations calls for assets/liabilities (including intangible assets and contingent liabilities which did not exist on the balance sheet of target entities/businesses) acquired in a deal to be measured at fair value applying appropriate valuation methods and residual value allocated to goodwill/capital reserve.

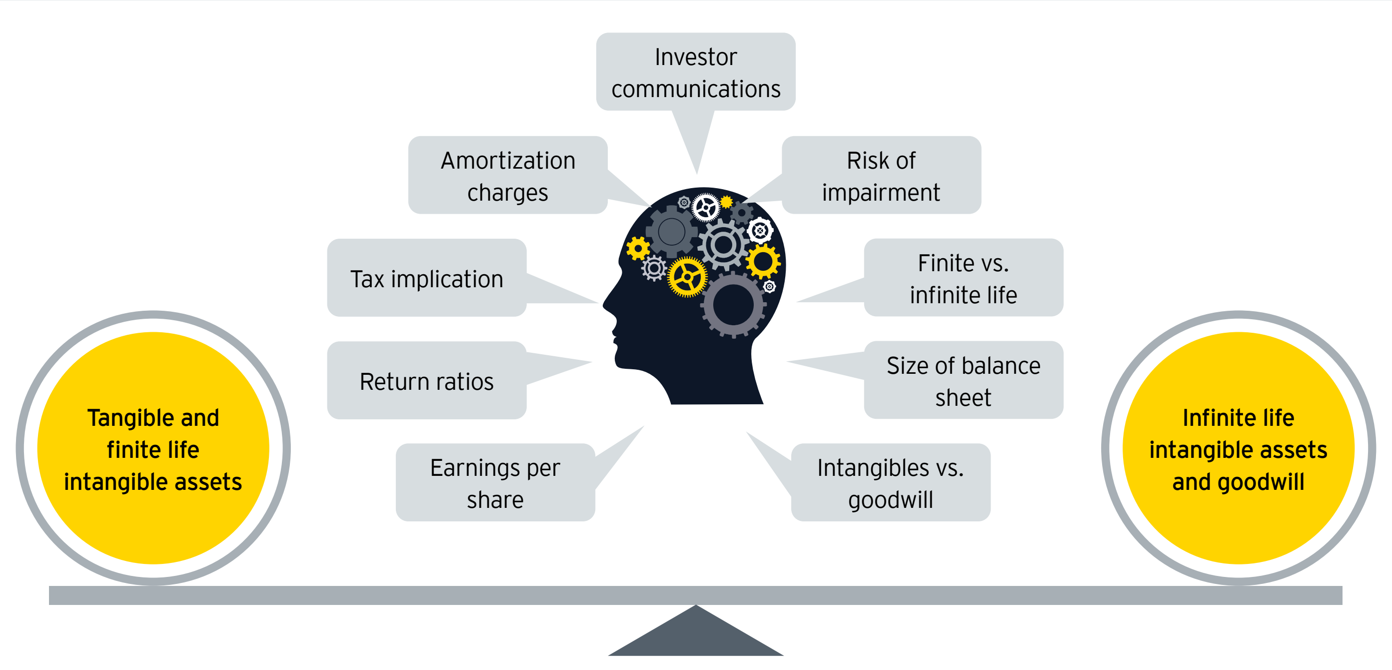
Understanding the implications of Ind AS 103 is important since they not only affect future earnings and balance sheet of a company but may also have tax implications, questions from shareholders, etc. Further, in the era of intense auditor and regulatory scrutiny, this matter warrants careful attention.

Depending on the transaction structure, purchase price allocation (PPA) will also have relevance from an income-tax perspective, as tax treatment for different intangibles and goodwill could be different.

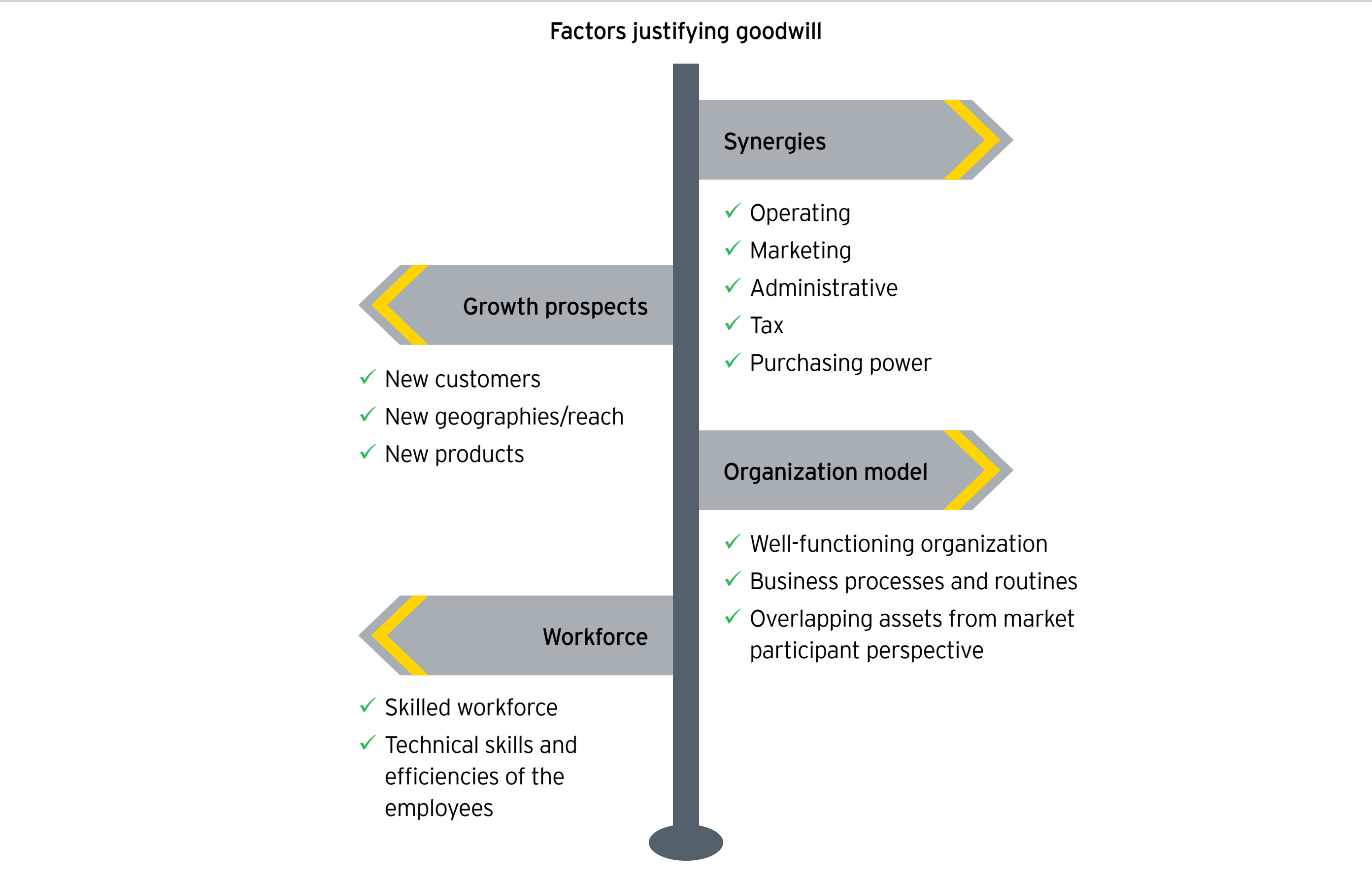
Ernst & Young Merchant Banking Services LLP's Valuation, Modelling & Economics Services has undertaken a study of business combination accounting for transactions that were disclosed in annual reports of top 500+ listed companies in India (covering over 400+ transactions) by market capitalization since implementation of Ind AS till 31 March 2021. The results of type of assets (primarily various intangible assets) that a company typically recognizes and reports in an acquisition are presented in this study. However, the results of this study cannot be viewed in isolation.

Our Valuation, Modelling & Economics Services' professionals are available to provide further insight on this, or on any other valuation topic, should you have any questions.

Fair value accounting of business combination and its manifold implications



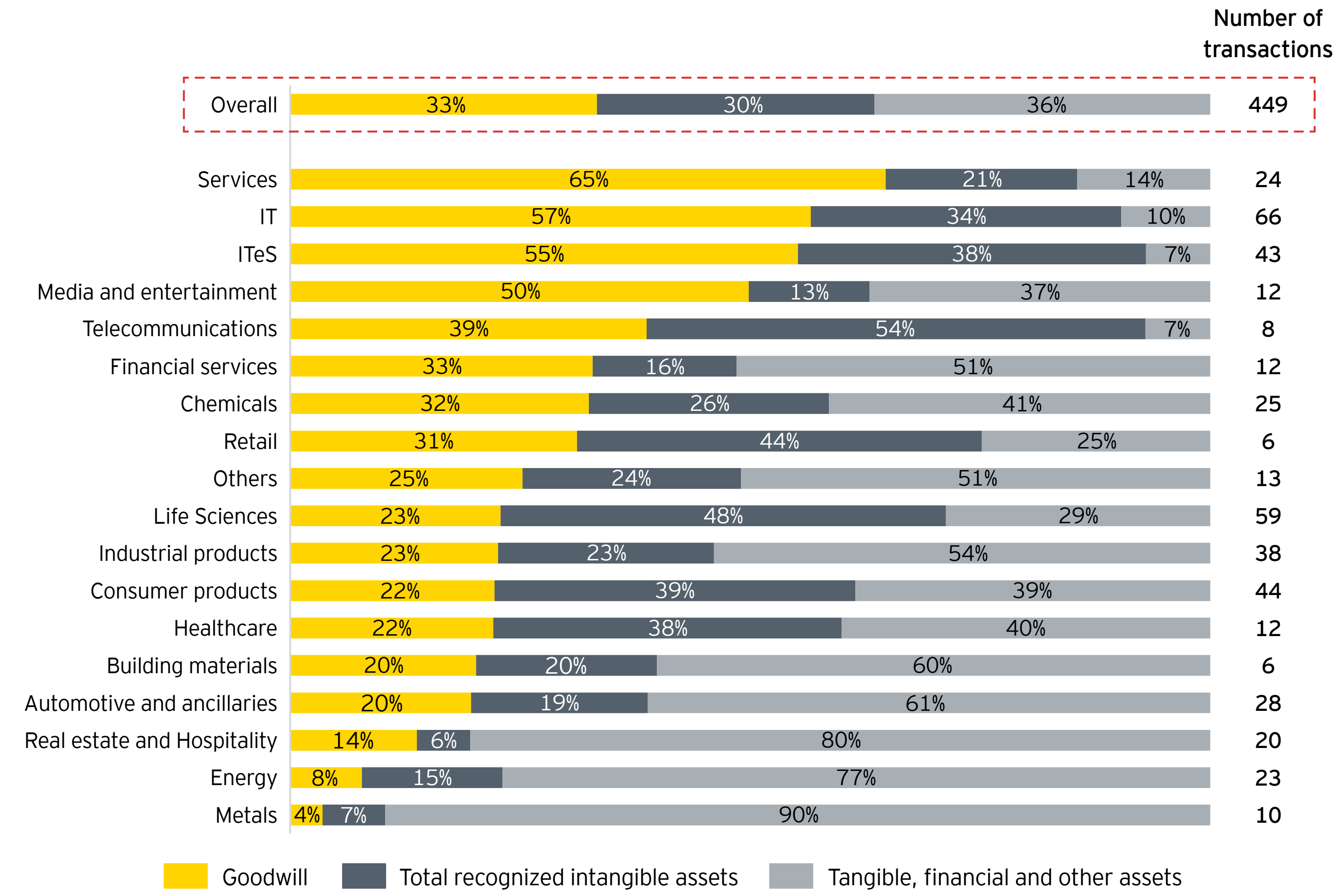
Goodwill: an important element



Key findings

Based on the study, 30% of the enterprise value of acquired companies was allocated to identified intangible assets and 33% was attributable to goodwill, with the allocation varying considerably from industry to industry.

The allocation to goodwill in India is largely in line with the proportion allocated in global deals (e.g., in the US).



*Tangible, financial, and other assets for financial services are higher due to higher composition of financial assets (i.e., loans and advances)

Note 1: The above numbers are average and should not be considered as a benchmark for the sector as allocation of assets and goodwill may vary significantly based on transaction-specific facts.

Note 2: Sectors with less than five transactions such as infrastructure and logistics are categorized under "Others".

Note 3: Average goodwill is after considering adjustment for capital reserves. There are 52 such transactions.

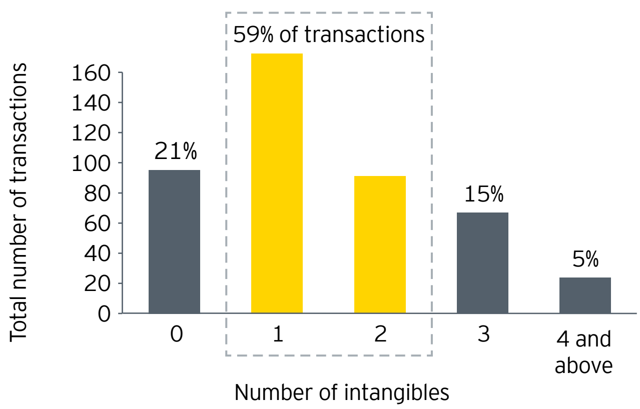
Sectors like telecommunications, life sciences, retail, consumer products, IT, ITeS and healthcare allocate their majority of deal value to intangible assets. This is reflected by the underlying products, brands, intellectual property and customer relationships.

While sectors like real estate and hospitality, energy, and metals, which are capital intensive, allocate more than two-third of their enterprise value to tangible assets.

In 21% of the transactions analyzed, no intangible asset was recognized. These transactions majorly originated from asset heavy sectors such as real estate and hospitality, energy, and industrial products.

Transactions where more than two intangible assets were identified majorly belonged to sectors like IT, ITeS, consumer products, chemicals and life sciences.

Number of intangibles identified



Frequency of intangible assets recognized by sector

Sector	Number of transactions	Brand/ Trademark/ IPR	Software/ Technology/ platform/design/ know-how	Customer contract/ relationship	Dealer network	Non-compete agreement	License and rights	Other intangibles
Automotive and ancillaries	28	32%	43%	21%	4%	4%		21%
Building materials	6	50%	67%	17%		17%	33%	33%
Chemicals	25	44%	32%	24%	8%	28%	4%	28%
Consumer products	44	66%	23%	20%	14%	9%	2%	14%
Energy	23	4%	22%	13%			17%	9%
Financial services	12	25%	42%	33%	8%		17%	17%
Healthcare	12	42%	25%	50%		17%	8%	8%
Industrial products	38	16%	24%	29%		21%	8%	16%
IT	66	38%	36%	76%	2%	21%	5%	17%
ITeS	43	47%	40%	81%	2%	21%	2%	19%
Life sciences	59	76%	24%	12%		3%	10%	12%
Media and entertainment	12	33%	42%	25%			17%	17%
Metals	10		10%	10%				30%
Retail	6	50%	33%		17%		17%	
Real estate and hospitality	20		5%				5%	15%
Services	24	25%	21%	46%		21%		54%*
Tele-communications	8	38%	38%	25%			38%	38%
Total	**436**	**40%**	**29%**	**36%**	**3%**	**12%**	**7%**	**19%**

0%   <15%   Between 15% to 30%   Between 30% to 45%   Above 45%

*Other intangibles in services sector appear higher as break-up of intangibles was not adequately disclosed.

Note: Sectors classified as "Others" are not considered in the analysis.

Marketing-related intangibles were the key acquisition driver in the consumer products, life sciences and retail sector.

Customer-related intangibles seem to be the acquisition driver in IT/ITeS sector. Though the frequency of marketing-related intangibles is high, the proportion of value allocated to such intangible is lower for the ITeS sector.

Allocation within intangible assets

The average allocation of an intangible asset's value within different types of intangible assets (excluding goodwill), recognized amongst sectors is tabulated below:

Sector wise	Brand/ Trademark/ Product/ ANDA*	Technology/ platform/design/ know-how	Customer contract/ relationship	Dealer network	Non-compete agreement	License and rights	Other intangibles
Automotive and ancillaries	25%	34%	21%	0%	1%		18%
Building materials	17%	2%	9%		6%	44%	22%
Chemicals	37%	15%	16%	6%	5%	1%	19%
Consumer products	64%	5%	11%	4%	1%	3%	11%
Energy	3%	18%	25%			36%	18%
Financial services	2%	38%	37%	5%		13%	5%
Healthcare	42%	13%	41%		0%	3%	1%
Industrial products	17%	16%	33%		13%	11%	11%
IT	9%	16%	59%	0%	2%	5%	9%
ITeS	10%	14%	64%	1%	2%	2%	7%
Life sciences	69%	13%	6%			5%	7%
Media and entertainment	19%	26%	32%			10%	14%
Metals		4%	29%				68%
Retail	50%	18%		17%		16%	
Real estate and hospitality		20%				20%	60%
Services	17%	5%	34%		4%		39%
Tele-communications	14%	21%	23%			37%	5%
Total	**26%**	**16%**	**27%**	**5%**	**3%**	**15%**	**20%**

0% <15% Between 15% to 30% Between 30% to 45% Above 45%

*ANDA: Abbreviated New Drug Application

Note: Sectors classified as "Others" are not considered in the analysis.

Allocation of value to the dealer network is amongst the lowest, implying that it is not a key driver for acquisitions, though considered a critical element for many industries.

Generally, a non-compete agreement is a part of most acquisitions as a safeguard to the buyer. However, allocation of value to non-compete agreement is on the lower side - possibly indicating either a shorter life or probability/impact of competition is/are perceived to be minimal.

Methodology

This study is based only on annual reports of the top 500+ listed companies in India by market capitalization for FY17 to FY21. Transactions with enterprise value less than INR 100 million and with goodwill more than 100% of the enterprise value were ignored. A total of 449 transactions were found where adequate information about PPA was disclosed. Appropriate assumptions were considered with regard to classification of intangibles where full information was not disclosed.

For certain transactions, only the total value was disclosed for all intangible assets recognized. For such transactions, value of intangible assets was classified under other intangible assets.

Results are presented as percentages of enterprise value. If cash and cash equivalent are not disclosed, gross debt is assumed as net debt.

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