Axiom on Value

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Maximizing the Rate of Return on Your Next Acquisition: Why the Allocation of the Purchase Price Should Be Done Before the Deal Closes

When an acquisition (stock or asset deal) is completed, the purchase price needs to be allocated to the assets purchased. In our experience, the allocation exercise is typically done after the deal is completed. A typical allocation table is shown below.

Row		Fair Value	Useful Life
	Tangible Assets		
1	Current Assets	$3,398,957	
2	Net Fixed Assets	$212,880	
3	**Total Tangible (R1 + R2)**	$3,611,837	
	Intangible Assets		
4	Brand Name	$2,752,533	Indefinite
5	Non-Compete Agreements	$582,279	2 Years
6	Software	$23,441,235	12 Years
7	Components Database	$72,259	2 Years
8	Customer Relationships	$16,931,283	25 Years
9	Workforce	$1,258,685	
10	**Total Value of Intangible Assets Excluding Workforce (R4 + R5 + R6 + R7 + R8)**	$43,779,589	
11	**Tangible + Intangible Assets (R3 + R10)**	$47,391,426	
12	**Purchase Price**	$67,944,892	
13	**Goodwill (R12 - R11)**	$20,553,466	
14	**Enterprise Value**	$61,724,682	
15	**Tax Amortization Benefit**	$3,636,923	
16	**Enterprise Value Including Intangibles' Tax Amortization Benefit (R14 + R15)**	**$65,361,606**	

Notice that in this case the portion that is goodwill is quite large at about 30%. From a post-acquisition perspective the tax benefit (assuming an asset deal or a stock deal with a 338 election) associated with goodwill is no different than the tax benefit associated with the customer list, for example- one fifteenth is amortized for tax purposes. Hence, the usual view is that the allocation of purchase price between purchased intangible assets and goodwill has no cash flow implications. This is often not the case.

Here is the reason. Goodwill is the value the buyer expects to produce in excess of what could be produced by the assets alone. Now in most cases goodwill can be divided into two components. The first is seller goodwill or goodwill that the seller would be expected to produce if the business remained on is historical trajectory. This goodwill includes but is not limited to additions to the customer base for example and/or strategies designed to reduce historical customer loss rates. What the buyer should not pay for is buyer goodwill. Following the example used here, buyer goodwill would equate to additions to the customer base above what the selling entity would be expected to generate on its own. Hence, the minimum purchase price should include the standalone value of the assets purchased plus seller goodwill. Any increment in the purchase price above this level gives rise to buyer goodwill. While competitive conditions and capital availability may result in a market participant paying up, the only way to know the potential extent of the overpayment is to conduct an allocation of the expected purchase price to the assets purchased.

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