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Valuation Insights

Inside

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In this edition of Valuation Insights we discuss the highlights of the Duff & Phelps 2013 U.S. Goodwill Impairment Study done in conjunction with the Financial Executives Research Foundation. The study examined the general and industry trends of goodwill impairment of U.S. companies as well as the results of the annual survey of Financial Executive International members.

In our Technical Notes section we discuss special considerations outside of a purchase price allocation in connection with personal property. The topics covered in this article include valuations of personal property for purposes of financing or insurance, useful life studies for financial reporting and the benefits of a physical inventory and records reconciliation.

Our International in Focus section discusses the valuation requirements in the Alternative Investment Fund Managers Directive. The article outlines the steps that hedge funds and private equity managers need to take in order to comply with the valuation requirements of the directive by the transition period deadline of July 2014.

Finally, our Spotlight article discusses the final regulations released by the IRS associated with the capitalization of expenditures related to tangible property. The article outlines the new regulations that are effective for all taxpayers for tax years beginning on January 1, 2014, and highlights differences from the temporary regulations issued in 2011.

In every issue you will find industry market multiples which are useful for benchmark valuation purposes. We hope that you will find this and future issues of this newsletter informative and reliable resources.

Read this issue to find out more.

Duff & Phelps Publishes 2013 U.S. Goodwill Impairment Study

Duff & Phelps and the Financial Executives Research Foundation (FERF)[1] have released the results of the 2013 U.S. Goodwill Impairment Study (2013 Study). Now in its fifth year of publication, this annual comprehensive study continues to:

- Examine general and industry trends of goodwill and goodwill impairment of U.S. companies.
- Highlight any new regulatory developments impacting how the goodwill impairment test is performed.
- Report and analyze the results of the annual goodwill impairment survey of FEI members.

Highlights of the 2013 Study

The $51 billion of goodwill impaired by U.S. companies in calendar year 2012[2] was a 76% increase from the 2011 amount of $29 billion. However, impairments were heavily concentrated, with 47% attributable to the three largest impairment events. Absent these three events, the total goodwill impairment would have been of similar magnitude to that of the prior three years.

Approximately 67% of the total goodwill impairment recorded in 2012 was concentrated in just three industries: Information Technology, Industrials, and Healthcare. Information Technology jumped from fourth place in 2011 to first place in 2012 with the highest amount of goodwill impairment ($22 billion, or 43% of aggregate impairment), replacing Financials, which had the largest amount of GWI in each of the three previous years. The Industrials sector had the largest percentage of companies with impaired goodwill (8%) followed by Information Technology and Consumer Staples (both at 7%).

What's New in the 2013 Study?

The 2013 Study presents a sizable amount of information, and over time the manner in which this information is presented has necessarily evolved. For example, in the 2012 Study, 10 "Industry Spotlights" were introduced to enable a quick overview of relevant metrics and statistics for specific industries.[3] In the 2013 Study, additional tables (and accompanying discussion) now provide the reader with additional summary statistics over the last five years for each industry, in a format that allows for quick comparisons across industries.

Previous versions of the Study have also endeavored to focus on important issues that go beyond a mere reporting of frequency and trends in goodwill impairments. The original 2009 Study, for example, focused on the extraordinary amount of goodwill impairment ($188 billion) recognized by U.S. publicly-traded companies in 2008, at the height of the Financial Crisis. The 2010 and 2011 Studies examined the important question of whether companies with goodwill impairments underperform the market (they do, but most of the underperformance occurs prior to the actual impairment date).

The 2013 Study introduces an infographic displaying a variety of data points to aid in assessing goodwill and goodwill impairment trends over time: (i) M&A activity, (ii) goodwill "activity" (i.e., net goodwill added), (iii) goodwill impairment "concentration" attributable to the largest three impairment events, and (iiii) median market-to-book ratios for all U.S. publicly-traded companies in the 2013 Study versus the subset of those that have recorded goodwill impairment.

Highlights of the 2013 Survey of FEI Members

This survey of FEI members was conducted in the summer of 2013. The annual surveys have become an increasingly important tool for gaining some insight into the reasons for goodwill impairments and the valuation techniques used in impairment testing.

The feedback provided by 2013 survey respondents was instrumental in capturing FEI members' awareness of current best practices guidance being made available to assist with goodwill impairment analyses; namely (i) the draft AICPA Accounting and Valuation Guide Testing Goodwill for Impairment; and (ii) The Appraisal Foundation Valuation Advisory Discussion Draft – The Measurement and Application of Market Participant Acquisition Premiums (MPAP). Surprisingly, a significant proportion of respondents were unaware of these efforts: 50% of all respondents were familiar with the new goodwill guidance, whereas only 20% were aware of the MPAP valuation advisory.

Finally, we continued to monitor FEI members' use of the optional qualitative tests. 71% of public companies and 78% of private companies are not applying Step 0 and instead utilized the traditional Step 1 test for goodwill impairment.

New Overview of Canadian Goodwill Impairment Study

The 2013 Study features an overview of its companion publication, the Goodwill Impairment Study: Canadian Edition, first published in 2012 in cooperation with the Canadian Financial Executives Research Foundation (CFERF). The 2012 Canadian Study focused on the impact of transition from the prior Canadian (a.k.a., Pre-changeover) GAAP to IFRS and its effect on goodwill impairments. The 2013 Canadian Study is in the process of being updated to include an analysis of calendar-year 2012 goodwill impairments under IFRS, and will be available soon.

Please visit the Duff & Phelps website to obtain a complete copy of the 2013 U.S. Goodwill Impairment Study.

1. Financial Executives Research Foundation (FERF) is the non-profit 501(c)(3) research affiliate of Financial Executives International (FEI).
2. GM's $27 billion goodwill impairment charge in the fourth quarter was excluded due to the unique circumstances related to the initial recording and subsequent impairment of their goodwill.
3. Industries are defined throughout the *2013 Study* in accordance with Global Industry Classification Standard (GICS) codes. The "Industry Spotlights" are for the ten 2-digit "sector-level" GICS codes.

Technical Notes

Personal Property – Considerations Outside of a Purchase Price Allocation

There are a number of personal property (all tangible property that is not real estate) considerations that merit attention outside the context of a purchase price allocation. This article focuses on four of them: Financing, Insurable Value, Useful Life Studies and Physical Inventory and Reconciliation.

Financing

When collateral is special purpose in nature (e.g. personal property comprising a chemical plant) care must be taken with regard to the premise of value being contemplated. If Fair Value ("FV") is being sought, then the assets will only have material FV if they are valued under a continued use premise. The FV of special purpose assets manifests itself in the cash flows that are generated by the asset in use (e.g. chemical plant as a whole) as opposed to the uninstalled, piecemeal liquidation value of the assets which is immaterial.

Personal property of a more generic nature, such as mobile equipment, containers, and general machinery and equipment, is a more traditional source of collateral for asset based lending. Generally, lenders are interested in the orderly liquidation value "(OLV") of the assets. Appraisers tend to utilize an approach that simply aggregates individual asset OLV estimates. However, in an actual liquidation, it is unlikely one would be able to realize the sum of those OLVs for two reasons. First, not all the assets will sell or they may sell at a considerable discount to the individual transaction prices obtained from the appraiser's research. Secondly, depending upon the extent of the liquidation, certain expenses and liabilities (such as lease breakage fees, remediation costs, severance costs etc.) may be triggered significantly reducing the net proceeds realized.

Insurable Value

Insurance policies utilize a number of value definitions. The most common are replacement cost, depreciated replacement cost and reproduction cost. The insured's goal is to estimate the adequate amount of insurance in the event of a loss without paying premiums for excessive coverage. Companies may leverage valuations completed for other purposes to determine their insurance requirements. If so, certain nuances should be understood. The values derived from a purchase accounting valuation may include assets that may not be insurable (such as foundations) or may not consider ancillary costs, such as demolition and clean-up costs, that may be significant should an insurable event occur. Further, there may be obsolete assets that an insured would choose not to replace. Alternatively, there may be a need to replace a damaged asset with a costlier reproduction for compatibility reasons even though superior replacements are available at a lower cost.

Useful Life Studies

Book depreciation lives for fixed assets are typically established in broad categories as part of a company's chart of accounts. Estimations of lives are often made by accounting staff with limited input from the asset's users or engineering staff. Depreciation lives that are set too short result in unnecessarily high depreciation expense. Lives that are set too long can result in write-offs when the asset is retired from service. More often than not, conservative accounting estimates result in the use of shorter lives.

There are numerous examples where assets will last "forever", provided they are maintained properly. However, much of the components of these assets may have been rebuilt or replaced throughout their years of service. Somewhere along the line much of the original asset was "retired" and "new" assets added. In these cases it's appropriate to componentize the asset into its various parts. This will allow an analysis of the empirical evidence of how long a component remained in service before being rebuilt or replaced. One can then estimate an average life of the asset by weighting the life of each component by their cost of replacement. Other considerations in estimating depreciable lives should include technological obsolescence, depreciable lives used by companies with similar asset bases, and research of publicly available sources.

Physical Inventory and Reconciliation

Quite often a company's fixed asset accounting records do not provide the level of support necessary to adequately track and control the capital equipment. For example, aggregated project costs may have been recorded as single line items, asset descriptions may have been truncated, and/or retirements and asset transfers may not have been documented appropriately. In order to remedy this situation a uniform standard for fixed asset reporting should be designed, standard templates prepared and a physical inventory conducted with emphasis on the major assets. The inventory should be reconciled to the existing fixed asset ledger(s), with records added or removed and descriptions enhanced. The resulting document will satisfy Sarbanes-Oxley requirements, provide superior control in reporting and managing fixed assets, and may have an ancillary benefit of reducing property taxes.

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International in Focus
The AIFM Directive and Independent Valuation

The Alternative Investment Fund Managers Directive ("AIFMD" or "the Directive") is a broad piece of European Union regulation which governs managers of alternative investment funds (hedge funds and private equity funds and other such fund vehicles). The Directive became effective last summer, but some member states (most notably the UK) have allowed for a transition period through July 2014. The groundwork for the Directive was established over the last few years, so its requirements are no surprise to fund managers, who were quite vocal in their opposition of this heightened regulatory framework. AIFMD will have a profound impact on the way that alternative investment fund managers interact with investors and other stakeholders and how they structure their operations.

One aspect of the Directive that has not generated the same level of media coverage as others is the requirement for independent valuations. Addressing the subjectivity, transparency and judgement that are inherent in the valuation of illiquid investments is a focal point of the Directive's provisions regarding valuation. There are very specific steps that AIFMs must take in order to comply with these new valuation requirements, even for those managers with predominantly liquid investments.

The Directive requires valuations to be performed independently, either internally or externally. A complete outsourcing of the valuation function, however, is unworkable. In our experience, only the largest fund managers have the resources to ring-fence a valuation function that is wholly independent from deal teams. We believe that most fund managers will choose to perform their valuations with internal resources, but take steps to demonstrate independence such as engaging an independent valuation expert. An experienced and independent external valuation adviser can enhance AIFMs internal valuation procedures to meet the requirements of the Directive for a number of compelling reasons:

- To demonstrate objectivity and independence
- To address the requirements of many of the most prominent limited partners (LPs)
- To validate the AIFMs fair value conclusions
- To allow AIFMs to fulfil their fiduciary duties to determine fair value
- To address an increasingly key focal point for regulators around the world
- To adhere to industry "best practice"

The concept of fair value plays a central role in defining how the Directive addresses the independent valuation requirement. Fair value, under IFRS 13, is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." For actively traded securities, the determination of fair value is relatively straightforward – it is the prevailing market price – and there is little room for judgment. For illiquid securities, which do not trade in active markets, the determination of fair value requires subjectivity and judgment (as does the determination of what constitutes an "active market").

The European Commission's focus on valuation is particularly heightened wherever a manager may apply judgment. The use of subjectivity and judgment raises the potential for bias. This concern is shared not only by regulators, but also by LPs in a fund and by potential new investors. Concerns regarding valuation practices among closed-end private equity managers have also attracted a steady stream of attention from regulators over the past few years. The U.S. Securities and Exchange Commission in particular has initiated a number of recent high profile inquiries regarding how AIFMs represent the value of their assets, and has indicated that the number of such inquiries will likely increase.

How will AIFMs adapt? How will LPs and other investors react? How will regulators respond? All these questions remain to be answered. AIFMs have until next year to determine how to comply and adjust accordingly. You may learn more about AIFMD, including an outline of the steps that AIFMs should take to address valuations at www.duffandphelps.com/aifmd.

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Spotlight
IRS Releases Final Tangible Property Regulations

The IRS has released its long awaited final regulations associated with the capitalization of expenditures related to tangible property (TD 9636) commonly referred to as the "repair regs." The final regulations update and modify the temporary regulations released in 2011, and are effective for all taxpayers for tax years beginning on January 1, 2014.

Generally, the final regulations provide more taxpayer friendly rules and are easier and clearer to understand. The final regulations focus on five primary issues including the treatment of materials and supplies expenses, repairs and maintenance expenditures, capital expenditures, amounts paid in the acquisition or production of tangible property and, amounts paid for the improvement of tangible property.

The final regulations include updated de minimis rules, eliminating the previously established ceiling amount, and new guidance allowing taxpayers to expense costs for tax purposes following its financial reporting policies. They also retain safe harbor rules related to expensing routine maintenance costs, and provide additional examples to determine what is a betterment or restoration to tangible property.

In additional to the final repair regulations, temporary regulations have also been issued to address the partial disposition of tangible property. Final disposition regulations are expected by the end of 2013.

The final regulations also address internal policies that must be in place prior to January 1, 2014. Taxpayers must implement all necessary methods and changes no later than September 15, 2015, the extended due date for 2014 tax returns.

For more information contact **Matthew Jaimes**, Director, at +1 248 675 6934.

North American Industry Market Multiples
As of September 30, 2013

Industry	Market Value of Equity to Net Income U.S.	Market Value of Equity to Net Income Canada	MVIC to EBIT U.S.	MVIC to EBIT Canada	MVIC to EBITDA U.S.	MVIC to EBITDA Canada
Energy	15.2	17.7	17.1	16.7	11.1	8.0
Energy Equipment & Services	19.8	16.8	16.0	14.9	9.9	7.6
Integrated Oil & Gas	9.8	—	—	—	6.2	—
Materials	16.4	9.8	14.2	11.2	10.2	6.3
Chemicals	17.3	12.8	14.3	16.0	10.5	8.5
Diversified Chemicals	15.4	—	14.5	—	10.5	—
Specialty Chemicals	19.8	—	15.0	—	11.3	—
Construction Materials	21.5	—	35.8	—	13.0	—
Metals & Mining	14.0	8.3	13.8	9.7	10.2	5.5
Paper & Forest Products	12.6	15.0	14.2	12.6	9.6	7.6
Industrials	18.2	12.1	14.2	14.5	10.5	9.6
Aerospace & Defense	15.7	6.9	13.2	16.4	9.4	12.7
Industrial Machinery	17.5	8.9	14.9	15.0	10.9	10.6
Commercial Services & Supplies	19.2	16.9	13.8	14.6	9.2	8.0
Road & Rail	19.5	13.4	14.3	13.4	8.4	8.8
Railroads	17.2	—	13.3	—	9.3	—
Consumer Discretionary	17.5	14.9	13.8	12.3	10.3	9.3
Auto Parts & Equipment	15.2	—	14.2	—	8.2	6.5
Automobile Manufacturers	—	—	20.3	—	12.6	—
Household Durables	15.0	—	15.9	—	12.2	—
Leisure Equipment & Products	13.5	16.5	12.6	11.9	10.1	9.9
Textiles, Apparel & Luxury Goods	16.6	—	13.2	—	11.1	—
Restaurants	24.0	17.7	17.3	12.1	11.5	6.7
Broadcasting	16.5	—	13.3	—	10.4	—
Cable & Satellite	15.9	—	17.4	11.8	9.9	7.4
Publishing	18.1	7.7	12.8	9.0	9.6	6.0
Multiline Retail	14.4	—	11.3	—	7.3	—

Industry	Market Value of Equity to Net Income U.S.	Market Value of Equity to Net Income Canada	MVIC to EBIT U.S.	MVIC to EBIT Canada	MVIC to EBITDA U.S.	MVIC to EBITDA Canada
Consumer Staples	17.7	17.6	13.5	14.5	10.8	9.7
Beverages	18.1	21.2	15.6	—	12.5	10.3
Food Products	19.6	14.2	14.8	15.0	11.4	9.7
Household Products	18.5	—	13.8	—	10.2	—
Health Care	19.2	8.3	15.4	20.5	12.0	13.3
Health Care Equipment	23.2	—	15.5	—	12.3	—
Health Care Services	18.6	—	15.0	—	10.1	10.3
Biotechnology	13.0	—	18.3	—	15.3	13.3
Pharmaceuticals	13.7	—	15.6	23.5	11.1	17.3
Information Technology	18.9	16.8	17.1	17.2	13.4	13.7
Internet Software & Services	16.2	19.8	16.7	16.6	14.9	12.9
IT Services	21.4	11.2	15.6	18.3	11.7	12.5
Software	21.8	29.5	21.1	26.1	15.7	19.9
Technology Hardware & Equipment	18.5	15.0	16.1	16.8	12.2	12.9
Communications Equipment	18.8	9.6	18.0	15.8	14.1	12.0
Computers & Peripherals	18.7	—	15.7	—	11.8	—
Semiconductors	21.4	—	20.1	—	16.4	—
Telecommunication Services	17.6	13.0	14.8	12.2	7.0	6.9
Integrated Telecommunication Services	13.5	14.4	13.9	12.0	6.1	6.7
Wireless Telecommunication Services	22.1	—	25.0	—	9.2	—
Utilities	18.1	13.9	14.5	20.8	9.3	12.0
Electric Utilities	17.6	—	14.3	—	9.2	—
Gas Utilities	18.8	—	14.2	—	9.2	—

Industry	Market Value of Equity to Net Income U.S.	Market Value of Equity to Net Income Canada	Market Value of Equity to Book Value U.S.	Market Value of Equity to Book Value Canada
Financials	13.9	11.8	1.1	1.1
Commercial Banks	13.6	11.0	1.1	1.9
Investment Banking and Brokerage	19.5	13.0	1.2	1.0
Insurance	12.2	13.8	1.2	1.4

An industry must have a minimum of 5 company participants to be calculated. For all reported multiples in the U.S. and Canada, the average number of companies in the calculation sample was 94 (U.S.), and 37 (Canada); the median number of companies in the calculation sample was 43 (U.S.), and 13 (Canada). Sample set includes publicly-traded companies (private companies are not included). Source: Data derived from Standard & Poor's Research Insight and Capital IQ databases. Reported multiples are median ratios (excluding negatives). MVIC = Market Value of Invested Capital = Market Value of Equity plus Book Value of Debt. EBIT = Earnings Before Interest and Taxes for latest fiscal year. EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization for latest 12 months.

European Industry Market Multiples
As of September 30, 2013

Industry	Market Value of Equity to Net Income	MVIC to EBIT	MVIC to EBITDA
Energy	10.9	12.2	8.3
Energy Equipment & Services	12.6	12.6	9.6
Integrated Oil & Gas	10.9	7.3	4.6
Materials	14.6	14.1	8.7
Chemicals	19.3	14.7	9.5
Diversified Chemicals	—	—	—
Specialty Chemicals	20.7	15.1	11.0
Construction Materials	21.3	19.1	10.1
Metals & Mining	11.3	13.2	8.1
Paper & Forest Products	11.6	13.3	8.5
Industrials	16.5	14.4	10.2
Aerospace & Defense	18.4	15.2	10.2
Industrial Machinery	17.4	13.7	10.3
Commercial Services & Supplies	18.9	14.1	9.2
Road & Rail	11.1	14.3	7.3
Railroads	—	—	—
Consumer Discretionary	16.1	14.1	10.2
Auto Parts & Equipment	12.5	11.1	7.0
Automobile Manufacturers	9.9	—	11.1
Household Durables	15.6	13.3	9.9
Leisure Equipment & Products	14.7	13.6	10.0
Textiles, Apparel & Luxury Goods	18.7	15.5	11.2
Restaurants	21.7	15.4	11.6
Broadcasting	17.2	11.8	11.1
Cable & Satellite	—	—	10.4
Publishing	15.8	14.5	9.1
Multiline Retail	—	—	9.3

Industry	Market Value of Equity to Net Income	MVIC to EBIT	MVIC to EBITDA
Consumer Staples	16.3	15.3	10.8
Beverages	22.6	17.6	13.4
Food Products	15.5	14.8	10.4
Household Products	—	16.2	10.6
Health Care	20.7	16.2	12.2
Health Care Equipment	18.6	14.8	10.9
Health Care Services	13.9	11.7	8.9
Biotechnology	23.6	23.2	20.6
Pharmaceuticals	20.7	14.1	11.6
Information Technology	18.1	15.2	11.5
Internet Software & Services	22.0	22.1	17.3
IT Services	16.5	12.4	9.6
Software	21.1	15.9	11.9
Technology Hardware & Equipment	16.5	15.6	11.6
Communications Equipment	16.2	16.9	12.2
Computers & Peripherals	19.3	15.5	10.0
Semiconductors	18.1	16.9	11.9
Telecommunication Services	13.5	13.0	7.2
Integrated Telecommunication Services	13.6	12.4	6.2
Wireless Telecommunication Services	5.3	11.1	7.4
Utilities	13.7	15.2	9.5
Electric Utilities	13.3	15.5	9.3
Gas Utilities	—	—	—

Industry	Market Value of Equity to Net Income	Market Value of Equity to Book Value
Financials	12.5	1.0
Commercial Banks	11.6	0.6
Investment Banking and Brokerage	19.3	1.1
Insurance	10.8	1.2

An industry must have a minimum of five company participants to be calculated. For all reported multiples in Europe, the average number of companies in the calculation sample was 73 and the median number of companies in the calculation sample was 33. Sample set includes publicly-traded companies (private companies are not included). Source: Data derived from Standard & Poor's Research Insight and Capital IQ databases. Reported multiples are median ratios (excluding negatives). MVIC = Market Value of Invested Capital = Market Value of Equity plus Book Value of Debt. EBIT = Earnings Before Interest and Taxes for latest fiscal year. EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization for latest 12 months.

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