

Third Quarter 2012

Valuation Insights

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About Duff & Phelps



In this edition of Valuation Insights we discuss the Duff & Phelps Contingent Consideration Study. This Study examined 120 transactions over the period 2009 through 2011 which included earn-outs. The article summarizes our key findings from this analysis.

In our Technical Notes section we discuss new tax regulations related to the capitalization of tangible property. The article discusses the criteria to classify deductible repair costs from capitalized improvements and provides useful information on how your company may be eligible to benefit from these new rules.

Our International Spotlight section discusses valuation considerations in connection with Canada's conversion from Canadian Generally Accepted Accounting Principles to International Financial Reporting Standards.

Finally, our Spotlight article discusses Jouky Chang's return to Duff & Phelps after completing a two-year Professional Accounting Fellowship with the SEC.

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.](#)

Contingent Consideration Study

Earn-out Structuring and Valuation

Making successful acquisitions has been more important than ever during the difficult economic times of the past few years. Contingent consideration, especially in the form of earn-outs, is an increasingly popular mechanism both for closing deals and for addressing post-transaction performance uncertainties. From the buyer's point of view, contingent consideration not only allows management to gain comfort with the transaction, but also transfers risk to the sellers and incentivizes them to drive the business in the desired direction post-close. From the sellers' point of view, contingent consideration can allow them to participate in the upside post-close — an upside they usually have more faith will materialize than the buyer does. Contingent consideration thus helps deal teams close transactions, especially those for which there is a gap in expectations for future business performance between the buyer and the seller.

Due to the adoption in 2009 of new Financial Accounting Standards Board (FASB) requirements for business combination accounting which mandated the recognition of contingent consideration assets and liabilities at acquisition-date fair value, with changes in fair value over time typically flowing through earnings, conventional wisdom had anticipated a reduction in the use of contingent consideration. Instead, the prevalence of earn-outs in public company acquisitions of private targets has been growing. According to the American Bar Association Business Law Section 2011 Private Target Mergers & Acquisitions Deal Points Study, earn-out prevalence grew from 19 percent of public company acquisitions of private targets in 2006 to 29 percent in 2008 and 38 percent in 2010.

Given the increasing use of contingent consideration and its importance to our clients, Duff & Phelps has published its first

Contingent Consideration Study. This study leverages information on 120 transactions that included an earn-out and closed between 2009 and 2011. The primary objectives of the study were to characterize earn-outs by structure and duration, report on their relative magnitude and fair values, and provide insights regarding earn-out design and the impact of updating their fair value on earnings post-close.

Earn-out structures come in many different forms, designed to address the unique risks associated with each specific transaction. Earn-outs tied to top line metrics (e.g. revenues, bookings, units sold, gross profit, or assets under management) were the most popular structure in the study, comprising 60 percent of the transactions analyzed. Discussions with finance executives and deal teams indicate that top line-based earn-outs are often easier to define with clarity, helping to avoid disputes down the road. Sellers may perceive that it will be easier for them to impact, drive and control post-acquisition performance on top line metrics than on profitability metrics. Buyers may perceive that growth in revenues, number of customers, etc., will build long-term value in the business and/or strengthen the synergistic value with other parts of the buyer's business. Earn-outs tied to bottom line metrics (38 percent) and achievement of technical, R&D or regulatory milestones (26 percent) are also common structures. These percentages add to more than 100 percent, because contingent consideration structures can be tied to more than one type of metric (e.g., contingent consideration defined as a percentage of revenue that is only earned if earnings exceed a certain threshold).

The study transactions vary significantly based on how much of the transaction consideration was paid upfront versus how much was contingent on future events or

business performance. The median acquisition-date fair value of the contingent consideration was 20 percent of the total consideration transferred (upfront payment plus the fair value of the contingent consideration). For earn-outs with an overall cap, the median acquisition-date fair value was about half of the maximum possible contingent consideration.

Unsurprisingly, the fair value of contingent consideration liabilities can increase or decrease significantly over the course of time, for the very reason that the earn-out was put in place — the outcome is uncertain. For the study transactions, on average one year later the future had unfolded roughly according to expectations. However, more than one-third of the time, there was a significant increase or decrease in fair value of at least 25 percent in one year, with approximately an equal number of upside and downside changes in fair value. When suitably structured, the earn-out not only served its purpose of transferring risk to the seller, but also buffered future earnings from these ups and downs of the business. When structured without regard for earnings volatility, however, the earn-out actually increased the volatility of earnings for that one-year time period.

The study provides additional detail on earn-out metrics, structures, duration and valuation that cannot be presented here. The study also contains insights regarding differences in structure and valuation for a few industries in which earn-outs are more common and for earn-outs by public versus private acquirers.

The study will be available for download by the end of August at www.duffandphelps.com. For more information, please contact **Lynne Weber**, Managing Director, at +1 650-798-5565 or **Gary Raichart**, Vice President, at +1 650-798-5586.

Technical Notes

Tax Implications of the New Building Repair Regulations

In late December of 2011, the Treasury and the IRS released its long awaited Regulations (“Regs”) related to the capitalization of tangible property. The new Regs, while issued as Temporary and Proposed Regulations, still require that taxpayers follow them beginning in 2012. The Regs cover a range of issues, however, the topic that has attracted the most interest is the question of what costs are treated as repair costs, which are currently deductible, and what costs are required to be capitalized as an improvement. This question has drawn the most attention as it relates to buildings and their structural components.

Unit of Property

Under prior law, buildings had been viewed as a single unit of property. This treatment resulted in viewing the effect of a repair or improvement on the building as a whole rather than the component it most directly affected.

The Regs still generally view the building as a single unit of property, however, they require capitalization standards be applied to the affected building component rather than the building as a whole to determine if the expenditure is a deductible repair or a capitalized improvement.

Building Components

The Regs specifically identify several distinct building components. These include Heating, Ventilation & Air Conditioning (“HVAC”) systems, electrical systems, plumbing systems, gas distribution systems, fire protection systems, security systems, elevators & escalators, and the building structure which includes walls, roofs, finishes, doors, windows and other structural components.

When the taxpayer incurs a cost to repair or improve any of these systems, they must apply the capitalization standards to the component which it applies to, rather than to the building as a whole to determine if the expenditure is currently deductible or capitalized and depreciated over its appropriate tax life.

Capitalization Standards

The Regs require that an expenditure be capitalized if the cost incurred is paid to improve a unit of property. The unit of property is improved if the expenditure results in a betterment, or restoration to the unit of property, or if it adapts it to a new or different use. If none of these conditions apply the expenditure may be deducted.

The Regs provide definitions and examples of betterments, restorations, and adaptations to different uses. The most dramatic modification to previous IRS positions is the ability to now claim a loss on disposed components when improvements are made to the building.

Under previous law, if the taxpayer made an improvement to the building they would be required to capitalize and depreciate the cost of the new component. The taxpayer would also be required to continue to depreciate the component of the building that had been replaced because the building and its components were viewed as a single unit of property. Under the new Regs, if the expenditure is required to be capitalized, the taxpayer will still depreciate the cost of the new improvement over its appropriate tax life, but may now claim a loss on the building component that is being replaced.

Identifying the Cost of Building Components

While this new position presents taxpayers with a significant opportunity to immediately recover the cost of components being replaced, it also presents a challenge in the ability to identify and quantify the basis of the replaced or repaired building components.

If a breakout of original construction costs or detail from a cost segregation was included in the taxpayer’s fixed asset records at the time the building was placed in service, that may provide sufficient detail to determine the cost of the retired components. More often, however, the building basis is carried in a single asset account and there is no detail beyond the original building basis.

To identify these components, a cost segregation study can be performed at the time the building is acquired or on a retro-active basis to identify these components as well as take advantage of accelerated tax depreciation benefits that would result from the cost segregation study.

If the accelerated depreciation and detailed engineering analysis is not needed, a more general allocation of the building basis can be performed to identify and quantify the components discussed in the Regs. This level of detail should address any future dispositions as well as assist the taxpayer in identifying any dispositions that may have occurred from the time the building was first acquired. This allocation may be performed in conjunction with a purchase price allocation for tax or financial reporting purposes, as well as on a stand-alone basis.

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International in Focus

Valuation Considerations in Conversion from Canadian GAAP to IFRS

Can the adoption of a new set of accounting standards for publicly accountable enterprises (PAEs)¹ have potential valuation implications? Canada's transition from Canadian Generally Accepted Accounting Principles (GAAP) to International Financial Reporting Standards (IFRS) offers an interesting case study and frame of reference.

Background

For fiscal years commencing on or after January 1, 2011, most Canadian PAEs converted from Canadian GAAP to IFRS² and joined over 100 other countries, including countries in the European Union and much of the Pacific Rim, already requiring or permitting the use of IFRS. While the underlying business of these companies may not have changed³, the language in financial communications to stakeholders changed dramatically.

Canada moved from a relative balance between a rules-based and principles-based GAAP to IFRS, which emphasizes substance over form and allows CFOs potentially greater choice in accounting policy selection.

In some cases, IFRS conversion had material impact on both the financial reporting and valuation metrics of these PAEs.⁴ In this article we briefly explore a few of these potential effects.

As valuation professionals develop global valuation benchmarks and study trends in industry norms, and as CFOs evaluate their company's performance against their global competitors, these differences become relevant and should be adjusted for, where possible.

Differences Emphasized

Presented are two examples, among others, of valuation considerations related to IFRS conversion:

- **Asset Valuation Impacts:** The carrying amount of long-lived assets can change on IFRS conversion (and thereafter) due to fair value adjustments on conversion and changes to impairment rules, all of which can alter return on asset calculations and price-to-book metrics.
- **Revenue and EBITDA⁵ Impacts:** In certain industries, products and services are typically sold through a single contractually binding arrangement with multiple deliverables. Revenue recognition differences due to bundling (or not) of these 'multiple element arrangements' can impact revenue, EBITDA, and EBIT⁶ valuation multiples.

Case Study 1: Asset Valuation Impact

An analyst performing a valuation of a U.S.-based capital intensive multinational is collecting financial information for her set of comparable companies. She notes significant fluctuation in price-to-book ratios over the past three years for the comparables located in Canada. Both IFRS conversion and ongoing accounting requirements could be driving those differences. For example:

- **Property, Plant and Equipment ("PP&E")** and investment property at the date of IFRS conversion may be written up to fair value which results in higher asset values and reduced net profit in the future (as depreciation expenses increase).
- **Impairment testing of PP&E** moves from an undiscounted future cash flow method to the greater of (i) fair value less costs to sell; and (ii) value in use (a discounted cash flow approach). The shift from an

undiscounted to a discounted cash flow testing may result in impairments being more frequent under IFRS.⁷

Case Study 2: Revenue and EBITDA Impact

- **Canadian Company G** sells communication equipment bundled with related maintenance services. This arrangement has multiple deliverables throughout the contract life. An analyst following Company G notices a revenue decline in the year of conversion to IFRS. Does the decrease relate to a loss of business or IFRS interpretation?
- Compared with Canadian GAAP, IFRS has less detailed guidance for 'multiple element arrangements'. While there are no cash consequences (just a shift in accrued amounts), a change in revenue recognition policy may materially impact the income statement, with a related effect on accounts receivables and deferred revenue liabilities.
- The opportunity to recognize revenue earlier or later in the contract cycle can affect revenue and EBITDA multiples in any period. This becomes significant when analysts select a comparable set of companies reporting under different accounting standards, but do not appreciate these distinctions.

Concluding Thoughts

Be careful. The devil is in the details. Considering the impact of IFRS changes when analyzing Canadian or global companies is critical, as they could have a material impact on your valuation.

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1. In general, PAEs are companies that trade their equity or debt on domestic or foreign public markets.

2. Certain types of entities (rate-regulated and investment companies) were granted an optional adoption deferral.

3. We have not attempted to review the impact of market condition changes on PAEs over the transition period.

4. IFRS Changeover: A Guide for Users of Financial Report – A Canadian Performance Reporting Board Publication, July 2010

5. EBITDA – Earnings Before Interest, Tax, Depreciation and Amortization.

6. EBIT – Earnings Before Interest and Tax.

7. Conversely, under IFRS finite long-lived assets only have to be tested when there are signs of impairment, which may mitigate some of this impact. Additionally, indications that a previously recognized impairment loss no longer exists may result in impairment reversal.

Spotlight

Former SEC Fellow Returns to Duff & Phelps

Jouky Chang has returned to Duff & Phelps after completing a two-year Professional Accounting Fellowship in the Office of the Chief Accountant at the U.S. Securities and Exchange Commission (SEC). As a managing director in the Valuation Advisory Services practice, Jouky is based in Duff & Phelps' Washington, D.C. office. He focuses primarily on valuation issues related to financial reporting and complex financial instruments. At the SEC, Jouky focused on valuations, fair value measurements and accounting standard-setting activities.

Jouky's transition from the SEC underscores Duff & Phelps' commitment to thought leadership in connection with the latest regulatory developments. The firm consistently provides input to the SEC, FASB, IASB and other groups as they develop implementation guidance and new rules with valuation implications. Notably, former SEC chairman William H. Donaldson serves as Duff & Phelps' chief corporate advisor, Managing Director David Larsen participated in an SEC roundtable

discussion on International Financial Reporting Standards (IFRS), Managing Directors David Larsen and Paul Barnes are members of the FASB's Valuation Resource Group, Managing Director Paul Barnes is a member of The Appraisal Foundation's Steering Committee on Best Practices for Valuations in Financial Reporting, and Managing Director Greg Franceschi is Co-Chair of the AICPA's Impairment Task Force and a member of the AICPA's Business Combinations Task Force.



One financial advisory and investment banking services firm excels at navigating complex financial issues: Duff & Phelps. Our people have the analytical skills to get to the heart of issues and the experience to know which variables matter more. We find the right balance between analysis and instinct – that sweet spot that powers sound decisions. Learn more at www.duffandphelps.com

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North American Industry Market Multiples

As of June 30, 2012

| Industry | Market Value of Equity to Net Income | | MVIC to EBIT | | MVIC to EBITDA | |
|----------------------------------|--------------------------------------|--------|--------------|--------|----------------|--------|
| | U.S. | Canada | U.S. | Canada | U.S. | Canada |
| Energy | 13.6 | 13.0 | 13.2 | 13.1 | 7.9 | 6.5 |
| Energy Equipment & Services | 16.9 | 7.9 | 11.7 | 7.8 | 8.3 | 4.9 |
| Integrated Oil & Gas | 10.6 | — | 8.1 | 10.0 | 6.1 | 6.9 |
| Materials | 14.3 | 11.6 | 11.2 | 11.4 | 7.9 | 7.4 |
| Chemicals | 14.3 | 12.4 | 10.8 | 10.9 | 8.4 | 7.2 |
| Diversified Chemicals | 12.4 | — | 10.9 | — | 8.4 | — |
| Specialty Chemicals | 15.5 | — | 11.3 | 10.3 | 8.9 | 6.6 |
| Construction Materials | 15.6 | — | 28.1 | 31.6 | 9.8 | 11.3 |
| Metals & Mining | 13.0 | 10.5 | 10.9 | 10.2 | 7.8 | 6.7 |
| Paper & Forest Products | 14.8 | 11.1 | 11.3 | 11.0 | 7.0 | 9.7 |
| Industrials | 15.1 | 12.4 | 11.8 | 12.2 | 8.5 | 8.6 |
| Aerospace & Defense | 13.0 | 7.7 | 10.8 | 10.3 | 7.9 | 7.8 |
| Industrial Machinery | 15.6 | 9.3 | 11.2 | 12.2 | 8.6 | 11.3 |
| Commercial Services & Supplies | 16.9 | 12.7 | 11.9 | 13.4 | 8.3 | 8.3 |
| Road & Rail | 17.7 | 13.6 | 12.7 | 12.8 | 7.6 | 10.2 |
| Railroads | 18.5 | — | 13.8 | — | 10.1 | — |
| Consumer Discretionary | 15.4 | 12.4 | 11.9 | 10.9 | 8.5 | 7.7 |
| Auto Parts & Equipment | 8.3 | 9.1 | 9.2 | 7.6 | 5.3 | 5.1 |
| Automobile Manufacturers | 5.1 | — | 6.8 | — | 4.3 | — |
| Household Durables | 12.5 | — | 10.9 | — | 8.6 | — |
| Leisure Equipment & Products | 20.4 | — | 13.4 | — | 10.2 | — |
| Textiles, Apparel & Luxury Goods | 15.5 | 17.0 | 12.2 | 15.3 | 10.1 | 10.2 |
| Restaurants | 20.0 | 19.0 | 14.4 | 9.9 | 8.9 | 9.3 |
| Broadcasting | 8.2 | — | 10.6 | 11.2 | 8.8 | 9.2 |
| Cable & Satellite | 16.4 | 18.1 | 14.0 | 10.9 | 8.1 | 5.7 |
| Publishing | 13.5 | 4.5 | 9.7 | 6.5 | 6.8 | 6.4 |
| Multiline Retail | 15.0 | — | 10.7 | — | 7.3 | — |

| Industry | Market Value of Equity to Net Income | | MVIC to EBIT | | MVIC to EBITDA | |
|---------------------------------------|--------------------------------------|--------|--------------|--------|----------------|--------|
| | U.S. | Canada | U.S. | Canada | U.S. | Canada |
| Consumer Staples | 15.7 | 17.0 | 12.3 | 13.5 | 9.1 | 10.1 |
| Beverages | 16.4 | 16.3 | 16.0 | 12.9 | 11.8 | 9.2 |
| Food Products | 14.6 | 21.9 | 11.9 | 14.9 | 9.0 | 10.3 |
| Household Products | 17.0 | — | 13.0 | — | 9.1 | — |
| Health Care | 17.8 | 12.4 | 13.5 | 13.6 | 10.4 | 11.6 |
| Health Care Equipment | 20.5 | — | 15.0 | — | 12.6 | 11.8 |
| Health Care Services | 19.5 | — | 12.8 | — | 8.7 | 8.0 |
| Biotechnology | 16.8 | 8.4 | 16.8 | 14.1 | 17.4 | 9.9 |
| Pharmaceuticals | 14.6 | 11.5 | 12.5 | 18.8 | 9.1 | 14.4 |
| Information Technology | 18.1 | 12.3 | 15.3 | 11.9 | 11.4 | 9.5 |
| Internet Software & Services | 27.7 | 24.6 | 23.5 | 19.8 | 16.7 | 7.3 |
| IT Services | 18.3 | 13.5 | 13.6 | 14.1 | 10.0 | 10.3 |
| Software | 24.4 | 17.4 | 21.3 | 20.3 | 14.8 | 13.9 |
| Technology Hardware & Equipment | 16.0 | 7.1 | 12.7 | 10.0 | 10.1 | 6.6 |
| Communications Equipment | 18.1 | 6.2 | 14.1 | 7.2 | 10.8 | 7.8 |
| Computers & Peripherals | 16.8 | — | 12.0 | — | 11.4 | — |
| Semiconductors | 21.8 | — | 19.0 | — | 13.4 | — |
| Telecommunication Services | 16.0 | 12.5 | 14.0 | 11.4 | 6.0 | 6.6 |
| Integrated Telecommunication Services | 21.3 | 13.4 | 13.2 | 11.4 | 5.7 | 6.6 |
| Wireless Telecommunication Services | 15.6 | — | 13.7 | — | 5.9 | — |
| Utilities | 17.9 | 17.4 | 14.8 | 23.8 | 9.4 | 12.5 |
| Electric Utilities | 16.8 | — | 14.4 | — | 9.2 | — |
| Gas Utilities | 18.5 | — | 14.2 | — | 9.7 | — |

| Industry | Market Value of Equity to Net Income | | Market Value of Equity to Book Value | |
|----------------------------------|--------------------------------------|--------|--------------------------------------|--------|
| | U.S. | Canada | U.S. | Canada |
| Financials | 14.5 | 11.2 | 1.0 | 1.4 |
| Commercial Banks | 12.9 | 10.4 | 0.9 | 1.8 |
| Investment Banking and Brokerage | 18.8 | — | 1.2 | 0.6 |
| Insurance | 12.3 | 15.7 | 0.8 | 1.1 |

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 104 (U.S.), and 49 (Canada); the median number of companies in the calculation sample was 55 (U.S.), and 9 (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.

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