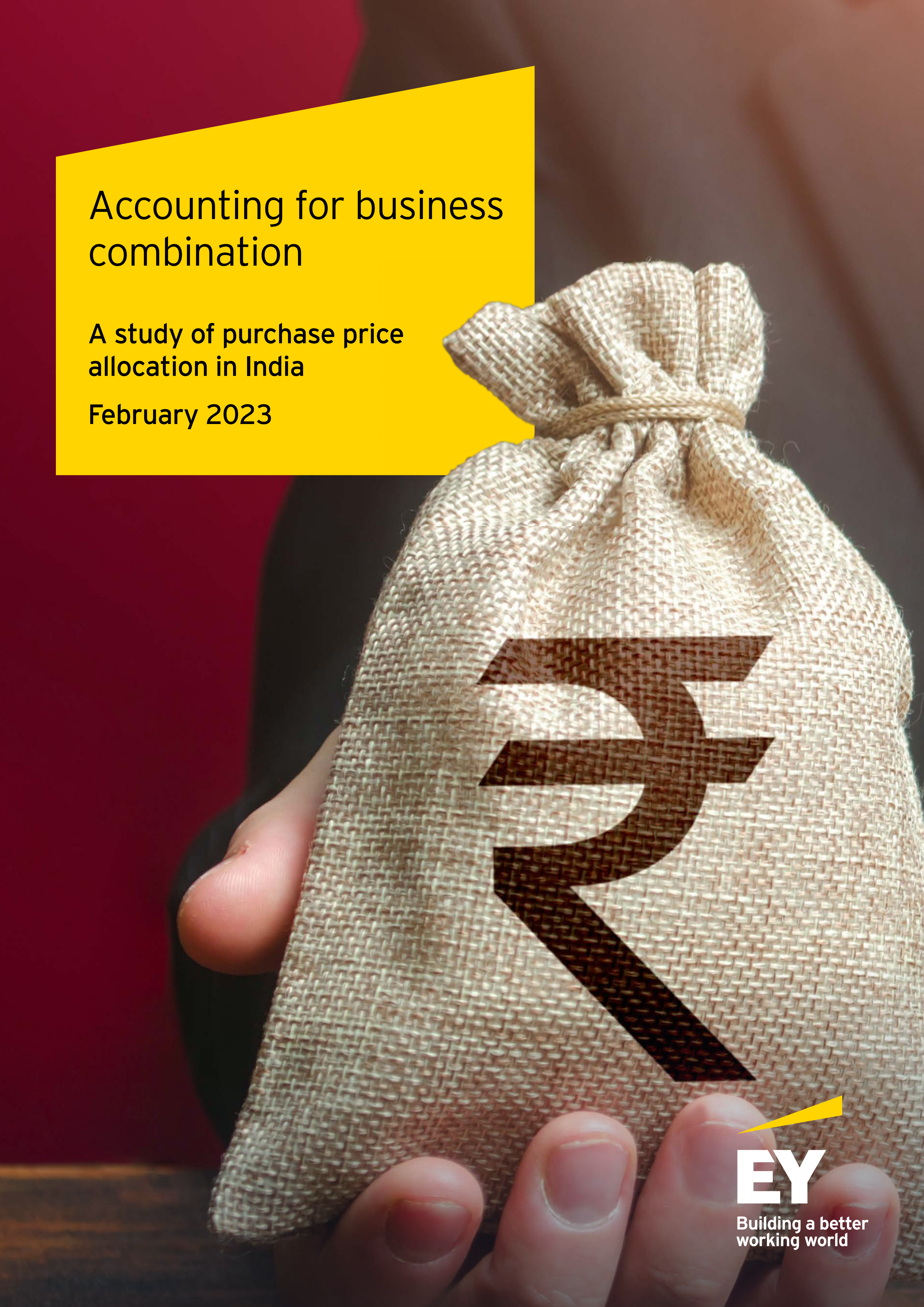
Accounting for business combination

A study of purchase price allocation in India

February 2023



Building a better working world

Foreword

We are proud to present the fourth edition of our Purchase Price Allocation (PPA) study.

Post COVID-19, the number of Mergers & Acquisitions increased during the year ended 31 March 2022, particularly in the backdrop of declined M&A activity during the previous year which was impacted due to the pandemic.

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 the 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, 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 department has undertaken a study of business combination accounting for transactions that were disclosed in annual reports of the top 500+ listed companies in India (covering over 500+ transactions) by market capitalization since implementation of Ind AS till 31 March 2022. The study presents the results of assets (primarily intangible assets) that are typically recognized and reported by a company during an acquisition. However, the results of this study cannot be viewed in isolation.

Why benchmarking?

Ind AS has consistently emphasized the importance of precise business combination accounting. While valuation guidelines may be prescribed in detail, assumptions and workings are still highly subjective in nature. An independent reasonable test is very important. A thorough PPA study will help in keeping a check with other transactions in a similar space. The study will help the management, auditors, tax officers and other advisors to assess the reasonableness of an individual PPA and predict the M&A impact on amortization expense.

Should you have any questions, our Valuation, Modelling & Economics Services' professionals are available to provide further insights on this study or on any other valuation topic.

Parag Mehta

Partner, Strategy and Transactions (SaT)
Valuation, Modelling & Economics

Ernst & Young Merchant Banking Services LLP

Fair value accounting of business combination and its manifold implications

Investor communications

Amortization charges

Risk of impairment

Tax implication

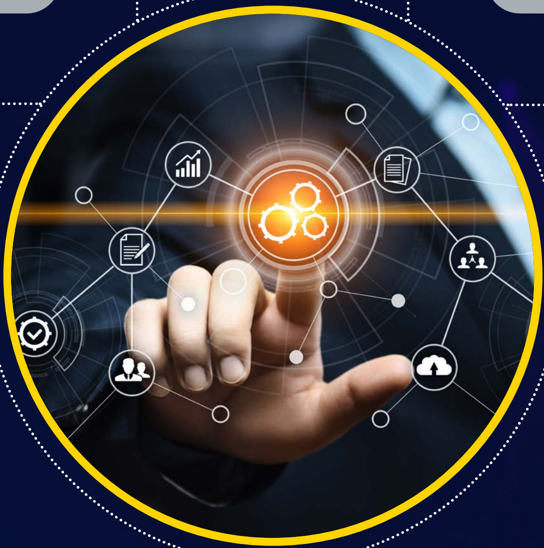
Finite vs. infinite life

Return ratios

Size of balance sheet

Earnings per share

Intangibles vs. goodwill



Tangible and finite life intangible assets

Infinite life intangible assets and goodwill

Goodwill: an important element

Factors justifying goodwill

Synergies

- ✓ Operating
- ✓ Marketing
- ✓ Administrative
- ✓ Tax
- ✓ Purchasing power

Growth prospects

- ✓ New customers
- ✓ New geographies / reach
- ✓ New products

Organization model

- ✓ Well-functioning organization
- ✓ Business processes and routines
- ✓ Overlapping assets from market participant perspective

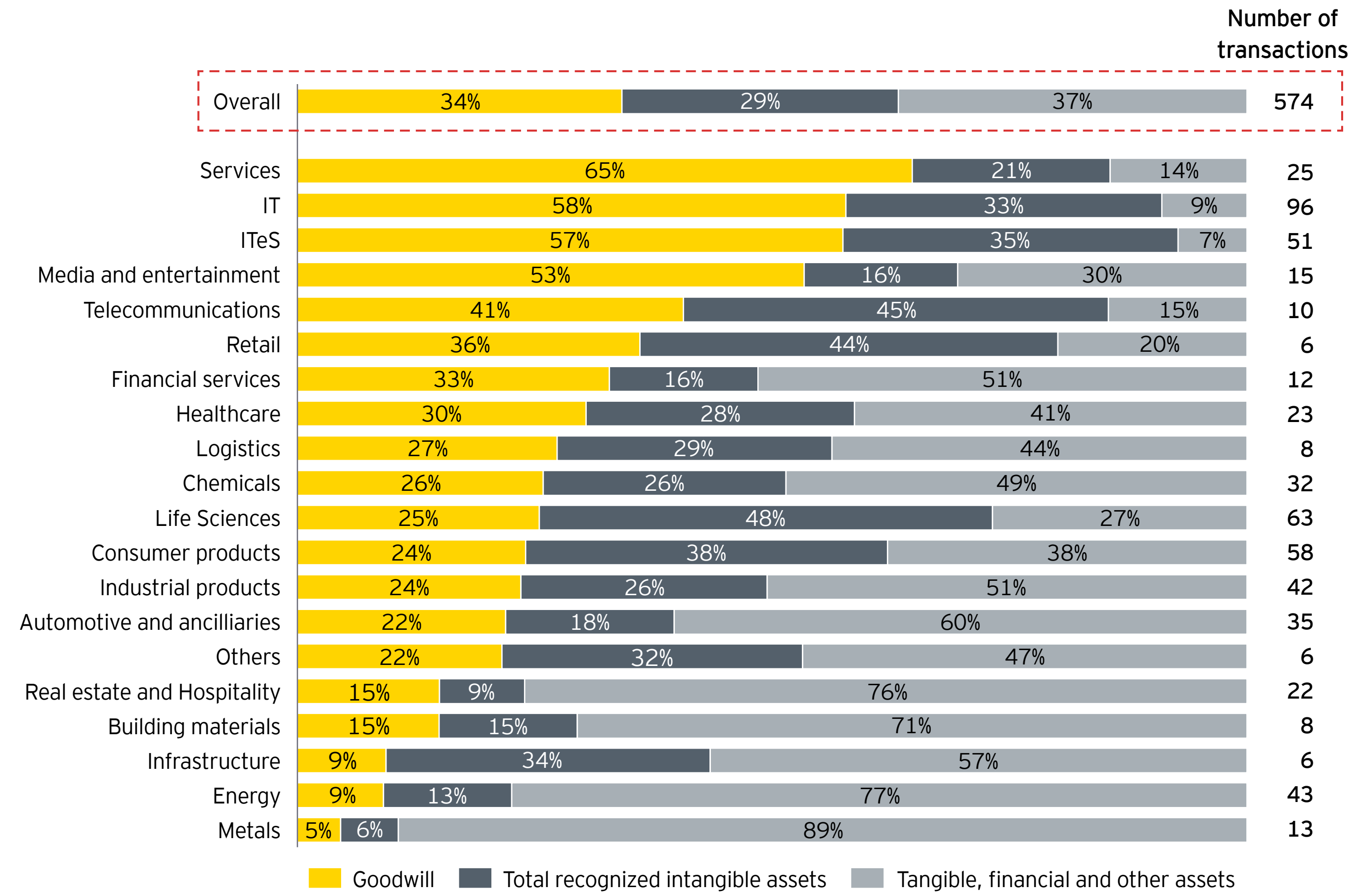
Workforce

- ✓ Skilled workforce
- ✓ Technical skills and efficiencies of the employees

Key findings

Based on the study, 29% of the enterprise value of acquired companies was allocated to identified intangible assets and 34% 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 are categorized under "Others".*

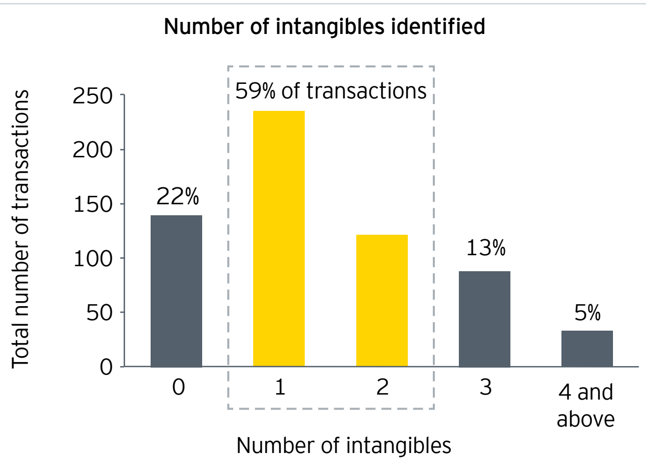
Note 3: *Average goodwill is after considering adjustment for capital reserves.*

In sectors like telecommunications, life sciences, retail and consumer products, a relatively higher proportion of deal value is allocated to intangible assets. This is reflected by the underlying products, brands, intellectual property, license and rights and customer relationships.

Capital-intensive sectors, such as real estate and hospitality, energy, metals and building materials, allocate more than two-third of their enterprise value to tangible assets.

In 22% of the transactions analyzed, no intangible asset was recognized. These transactions majorly pertained to asset heavy sectors, such as real estate and hospitality, energy, industrial products, automotive and ancillaries, etc.

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



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	35	26%	34%	20%	3%	3%		26%
Building materials	8	38%	50%	13%		13%	25%	38%
Chemicals	32	38%	28%	22%	6%	19%	3%	34%
Consumer products	58	48%	22%	19%	10%	12%	5%	19%
Energy	43	5%	14%	19%			9%	19%
Financial services	12	25%	42%	33%	8%		17%	17%
Healthcare	23	30%	13%	26%		17%	4%	35%
Industrial products	42	17%	24%	26%		19%	10%	21%
Infrastructure	6		33%				50%	50%
IT	96	32%	32%	74%	2%	24%	3%	21%
ITeS	51	41%	33%	76%	2%	18%	2%	29%
Life sciences	63	73%	22%	13%		3%	10%	16%
Logistics	8	25%	38%	38%	13%	25%	25%	50%
Media and entertainment	15	20%	27%	20%		7%	13%	33%
Metals	13		8%	8%				46%
Retail	6	50%	33%		17%		17%	
Real estate and hospitality	22	5%	5%	5%			5%	18%
Services	25	24%	20%	40%		16%		56%
Tele- communications	10	30%	30%	20%			30%	30%
Total	**568**	**33%**	**26%**	**34%**	**3%**	**12%**	**7%**	**26%**

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

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

** Other intangibles in services, infrastructure, logistics and metals sector appear higher as the break-up of intangibles was not adequately disclosed.*

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.

Allocation within intangible assets

The average allocation of an intangible asset's value within different types of intangible assets (excluding goodwill), recognized among 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	22%	30%	23%		1%		25%
Building materials	13%	2%	7%		5%	35%	38%
Chemicals	34%	12%	13%	5%	4%	1%	31%
Consumer products	50%	8%	12%	3%	2%	7%	18%
Energy	2%	11%	33%			19%	35%
Financial services	2%	38%	37%	5%		13%	5%
Healthcare	35%	7%	17%		1%	2%	38%
Industrial products	15%	16%	28%		11%	10%	19%
Infrastructure		20%				60%	20%
IT	8%	14%	60%		3%	3%	12%
ITeS	10%	11%	58%	1%	2%	2%	15%
Life sciences	65%	12%	7%			4%	11%
Logistics	10%	2%	26%	9%	13%	18%	23%
Media and entertainment	10%	18%	23%		4%	7%	38%
Metals		2%	14%				84%
Retail	50%	18%		17%		16%	
Real estate and hospitality	8%	14%	7%			14%	57%
Services	20%	5%	31%		3%		41%
Tele-communications	14%	21%	23%			37%	5%
Total	**19%**	**12%**	**22%**	**4%**	**4%**	**14%**	**25%**

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

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

Dealer network is an important intangible in Retail and Logistics sector.

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 FY22. Transactions with enterprise value less than INR100 million were ignored. A total of 574 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, the 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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