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Valuation updates | Valuation of non-compete agreements

October 2017

This thought leadership paper provides insights on valuation of non-compete agreements.

Introduction to non-compete agreements

A non-compete agreement in the context of a business combination, is a covenant to the stock/asset purchase agreement that prohibits the former owner/key employees of the seller business from competing with the business of the seller in the future. Such covenants usually last for a specified period of time and may apply to a specific geographic area *(generally the area currently being served by the subject company)*.

In an effort to retain the key personnel in a sale of a business, an acquirer will often include non-competition provisions within an employment agreement and/or as a separate non-competition agreement. In the absence of an agreement, an employee would be free to engage in a competing business resulting in potential loss of business for the acquirer.

Recognition of non-compete agreements as an intangible asset

Accounting standard codification 805: Business Combinations ('ASC 805') states that an intangible asset should be recognized and recorded as an asset separate from goodwill when it:

i. Arises from contractual or other legal rights; or
ii. Is capable of being separated or divided from the acquired business and sold, transferred, licensed, rented or exchanged.

Drawing inference from the above definition, a non-compete agreement may not be separable but shall be recognized as an intangible as it arises from contractual rights and thus per the measurement criteria laid down in ASC 805, a fair valuation is necessary.

Valuation of non-compete agreement

Non-compete agreements provide the acquirer with a measure of comfort in that the expected stream of earnings from the business being acquired will not be disrupted by competition from the former owner/employees. The seller benefits because the buyer has confidence that the anticipated earnings will materialize and therefore the seller can maximize the purchase price. Therefore, the value of a non-competition agreement is derived from the protection provided to the new owners from the loss of expected cash flows of the business due to the potential of future competition.

While valuing a non-compete agreement there are two questions that need to be answered:

- How much of the future earnings could the former owner take from the company if he/she decided to compete against the new company?
- What is the likelihood that the former owner would compete?

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Valuation of non-compete agreements

One of the most common methods applied for valuation of non-compete agreements is the **lost profits method** under the income approach of valuation. The rationale for this method is based on the fact that the value of a non-compete is implied from the profits that would have been lost given the key employees/former owners disassociate themselves from the entity formed post acquisition and commence a competing business. It is pertinent to note that the non-compete has value only when the persons covered under the agreement actually leave and compete. Thus, the probability for the same needs to be captured which is often a management assumption.

The value of the non-compete would thus be equal to the potential lost profits adjusted for such probabilities. The resulting income stream is then discounted to present value using an appropriate discount rate. A non-compete agreement is a definite lived intangible asset and is thus amortizable for tax purposes. For GAAP purposes, it is amortized over its useful life which is usually equal to the contractual period of the agreement. Thus, a tax amortization benefit *('TAB')* is factored in the fair value to reflect the potential tax benefits accruing on account of amortization of the non-compete agreement as an intangible.

Illustration:

Particulars	2016	2017	2018
Projections with non-compete in place			
Total revenue *(1)*	1000	1500	2000
EBIT *(2)*	200	250	500
Operating margin *(1/2)*	**20%**	**17%**	**25%**
Projections without non-compete in place			
Lost revenue due to competition *(3)*	200	300	600
Operating margin *(4)*	20%	17%	25%
Lost profit-EBIT *(3*4)*	40	51	150
Minus: Taxes *(assumed at 40%)*	(16)	(20.40)	(60)
After tax lost profit	**24**	**30.60**	**90**
Profit lost if competition starting in year 2016	24	30.60	90
Profit lost if competition starting in year 2017		30.60	90
Profit lost if competition starting in year 2018			90

Expected profit lost:

Particulars	P*(a)*	P*(b)*	P*(a*b)*	P*(c)*	P*(a*b*c)*	2016	2017	2018
Decision to leave in 2016 and compete in 2016	0%	100%	0%	0%	0%	0	0	0
Decision to leave in 2017 and compete in 2017	10%	100%	10%	0%	0%		0	0
Decision to leave in 2018 and compete in 2018	80%	90%	72%	10%	7%			6.30[1]
Adjusted annual after tax lost profit						**0**	**0**	**6.30**
Present value factor *(assumed at 10%)*						0.91	0.83	0.75
Present value of after tax lost profit						**0**	**0**	**4.73**
Sum of present value of after tax lost profit								**4.73**
Tax saving of amortization								1.53
Fair value of non-compete clause								**7.24**

[1] *6.30 = 90*7%*

Valuation of non-compete agreements *(cont…)*

Notes:
P*(a)*: Probability of leaving
P*(b)*: Probability of not having previously left
P*(c)*: Probability of competing

- The above illustration is based on fair valuation of a non-compete agreement entered into for a period of 3 years between the acquirer and the former owners of the seller company;
- The after tax lost profits have been adjusted for the joint probability of the owner having left the company and competing; &
- These adjusted lost profits are then discounted back to the present value and adjusted for a TAB factor.

Non-compete agreements are an inherent part of most of the business combinations that take place. However, the value driver for the non-compete clause is the probability of the employee leaving and competing. Clauses in agreements such as employee retention escrow payments or clawback provisions pertaining to retention of employees often lead to the non-compete clause having an immaterial value as an intangible on the balance sheet of the acquirer.

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