Opening the Kimono on Contract Valuation

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Valuation analysts are often called on to value the contract and expected contract renewal intangible asset. These valuations are performed for a variety of accounting, taxation, transaction, financing, regulatory, litigation, and other purposes. There are generally accepted approaches, methods, and procedures related to the valuation of this contract-related intangible asset. In this discussion, the author proposes a de novo valuation method for the valuation of commercial contracts. This de novo valuation method applies the income approach to intangible asset valuation.

Introduction

The valuation of a contract intangible asset can be akin to an inaugural space exploration without the benefit of a travel plan or telescope. The valuation analyst's assessment can be generally in the right direction, but still light-years away from any known landmarks.

One of the challenges with valuing the contract intangible asset is that the valuation analyst may not have the benefit of a body of research to act as a road map. However, the valuation analyst can embark on what some may describe as "mission impossible" by making a determination as to which one or more of the generally accepted valuation approaches (cost, market, or income) provides the most suitable framework for the valuation.

The Cost Approach

The cost approach would suggest that the contract intangible asset value is a function of the cost of producing that intangible asset. In the author's opinion, this valuation approach is not particularly useful for valuing the contract intangible asset. This is because the costs associated with drafting a contract are generally untethered to its value.

When Henry Kravis was negotiating the acquisition of RJR Reynolds, the RJR board of directors could not decide which of its suitors it should sell itself to by the deadline that Mr. Kravis gave them.

The RJR board of directors asked for more time to contemplate Mr. Kravis' acquisition offer. Mr. Kravis agreed. And, Kravis and his lawyer quickly scribbled out a handwritten agreement on a legal pad that granted the RJR board of directors another 45 minutes to deliberate in return for a $45 million option payment.

Warren Buffett said that he made the decision to invest $5 billion in Goldman Sachs within a few hours as he was eating jelly beans and sipping Cherry Coke.

On the other hand, business is rife with companies paying tens of millions of dollars in legal fees for business ventures and acquisitions that deliver negative shareholder returns.

The Market Approach

In the author's opinion, the market approach may not work for valuing the contract intangible asset. This is because there is no active secondary market for the sale of most contracts. The limited efforts at selling contracts have been retarded by several factors.

Charles McCormick, a lawyer with McCormick & O'Brien, LLP in New York City, points out that:

- Customer contracts may be terminable upon relatively short notice (e.g., 30 to 90 days) for any reason. This optionality works against the potential transferor.

- Many contracts hold that such contracts can be immediately terminable by the customer if the vendor becomes insolvent or declares bankruptcy. (However, such provisions are not always enforceable, due to the ipso facto principle.)
- Commercial contracts are not always assignable. Some commercial contracts contain outright restrictions on assignment. In other cases, various state court decisions (such as those in New York) have held that if the services to be performed under a contract are such that the customer is relying on some particular or unique aspect of the provider, assignment may require the customer's consent.

Seeking customer consent may also present an opportunity for the customer to renegotiate the contract. Such a renegotiation could ultimately make the contract less valuable to the performing party.

Income Approach

Contracts are both legal documents and intangible assets from which benefits are expected to be derived. In the author's opinion, the income approach is most appropriate for valuing contracts.

The income approach abbreviated formula for valuing contracts is:

Contract Value = Deposits + ((Anticipated Value of Contractual Income – Deposits) × Discount Rate) + Value of Ancillary Economic Benefits + (Recoveries × Discount Rate) – Transactions Costs

Overview of the Contract Valuation Process

The complexity of valuing contracts can be crystallized by discussing a simple example that parallels an assignment the author recently completed.

Let's assume that Seating Sisters has executed a contract with Bicycle Brothers in which the former will supply the latter with bicycle seats over the next four years. The contract includes an option to extend the contract by an additional two years.

A summary of this illustrative contract is provided in Exhibit 1.

Deposits

The first procedure in estimating the value of a contract is to assess whether the buyer has made any deposits to the seller. Any such deposits made shortly after the execution of the contract should be recorded without any discounting for the time value

Exhibit 1
Illustrative Example
Contract Summary
Bicycle Brothers and Seating Sisters

Customer: Bicycle Brothers (BB) Supplier: Seating Sisters (SS)

Purpose of the Contract: Seating Sisters will supply Bicycle Brothers with bicycle seats

Product Lines Affected by the Contract: Adult and children bicycle seats

A Review of the Contract Terms

	Initial Price per Unit	Annual Price Adjustments	Initial Annual Volume	Annual Volume Changes
Adult Bicycles	$9.00	-6.0%	500,000	10%
Children Bicycles	$7.00	-6.0%	250,000	12%
Deposit from BB to SS	$125,000			

	Contact Duration	Option to Renew[1]	Right of First Refusal[2]	Retraction Clauses[3]
Adult Bicycles	4 years	Yes, 2 years	No	Yes
Children Bicycles	4 years	Yes, 2 years	Yes	No

Notes:

1. Seating Sisters has an option to renew the contract on the same terms for an additional two years. Seating Sisters must be in compliance with all materials terms of the contract and provide Bicycle Brothers with six months notice of its intention to exercise its option.
2. Bicycle Brothers intends to expand its offerings of children's bicycles beyond its legacy markets in the northeastern United States. Should Bicycle Brothers manufacture bicycles for new geographic markets, Seating Sisters would have a right of first refusal to provide such seating requirements provided that it was in compliance with all material terms of its contract and its prices would be within 3% of the most competitive external bid.
3. Seating Sisters is required to meet a variety of standards in terms of product delivery. If the winning of Sister's bicycle seats fail to meet their requirements, Bicycle Brothers can restract certain of its orders according to a schedule which was part of the initial agreement.

of money. In this illustrative example, the buyer deposits total $125,000.

Anticipated Value of Contractual Income

The anticipated value of the contractual income can be broken into two parts: (1) performance related and (2) contingency related.

The performance related value is (1) the product of prices that the buyer agrees to pay times (2) the number of units the buyer agrees to purchase throughout the term of the contract. In this illustrative example (presented in Exhibit 2), the total revenue anticipated to be received from Bicycle Brothers is $26,513,157. This total revenue is reduced by deposits, fixed costs, variable costs, and income taxes.

The contingency value is determined by first assessing the expected values that could be derived if the contract contingencies were exercised. The second procedure is to multiply these expected values times the probabilities that such contingencies will be exercised.

In our illustrative example, there are three contingencies that affect Seating Sisters contract value: (1) renewal options, (2) rights of first refusal on supplying bicycle seats to new markets, and (3) retraction clauses that could result in Seating Sisters losing some of its markets if it does not deliver according to contract terms.

The revenue associated with these contingencies is $7,438,046, $4,666,361, and ($2,191,225), respectively.

The difficulty in valuing contingencies lies in estimating the probabilities of their occurrence. The following discussion summarizes the indicators that can be assessed to determine the probability of the occurrence of such contingencies:

- Historical Performance—What is the Bicycle Brothers history with respect to expanding its market geographically?
- Expected Market Conditions—The Seating Sisters willingness to exercise its option to renew its contract with Bicycle Brothers will be a function of expected economic conditions. The contract calls for delivering its seats to Bicycle Brothers for an annual 6 percent discount. If the costs of raw materials increase—or decrease less than 6 percent a year—then the renewal option may not be worth exercising.
- Changes in Business Plans—Have the contract parties changed their business plans? Perhaps, Bicycle Brothers has decided not to offer children's bicycles outside of its legacy markets. Therefore, the Seating Sisters right of first refusal would be worthless.
- Success of Competitors in the Industry—What is the magnitude of product improvements expected to be introduced by competitors? If competitors' products render the Seating Sisters products uncompetitive, then Bicycle Brothers could exercise its right to retract the markets currently awarded to Seating Sisters.

Guidance on these issues can be obtained through both primary research and secondary research. The valuation analyst may (1) interview industry authorities (such as executives and trade association officials) and (2) conduct channel checks by speaking with suppliers, distributors, and retailers.

This fundamental due diligence process may be complemented by reading the trade press, local newspapers, relevant blogs, and results from Internet searches.

Discount Rate

A discount rate should be applied to the anticipated value of contractual income in order to reflect the Seating Sisters costs of capital, opportunity costs, and risks of inflation that erode the value of future income. To this value should be added the risks of the contract being violated.

To gain more specificity as to what can go wrong with a contract—and thus what needs to be priced into the discount rate—the author interviewed more than two dozen leading business, litigation and contracts lawyers. Among the most helpful in constructing a discount rate model for assessing contract value were (1) Robert J. Feinberg, shareholder with Giordano, Halleran & Ciesa in Red Bank, New

Exhibit 2
Illustrative Example
Anticipated Value of the Contractual Income

		2010E	2011E	2012E	2013E	2014E	2015E
Contractual Revenue							
Adult Bikes	Price per unit	$9.00	$8.46	$7.95	$7.48	$7.03	$6.61
	Units	500,000	550,000	605,000	665,500	732,050	805,255
	Revenue	4,500,000	4,653,000	4,811,202	4,974,783	5,143,925	5,318,819
Children Bikes	Price per unit	$7.00	$6.58	$6.19	$5.81	$5.47	$5.14
	Units	250,000	280,000	313,600	351,232	393,380	440,585
	Revenue	1,750,000	1,842,400	1,939,679	2,042,094	2,149,916	2,263,432
Baseline Revenue		6,250,000	6,495,400	6,750,881	7,016,877		
Total Baseline Revenue			$26,513,157				
Option to Renew the Contract							
Value of the Option - Pre-Probabilities						7,293,842	7,582,251
Probability of Renewing						50%	50%
Value of the Option - Post Probabilities						3,646,921	3,791,125
Total Value of Renewal Option						$7,438,046	
Rights of First Refusal							
Size of Opportunity			2,210,880	2,327,614	2,450,513	2,579,900	2,716,118
Probability of Receiving			30%	40%	50%	40%	30%
Value of Opportunity			663,264	931,046	1,225,256	1,031,960	814,835
Total Value of Right of First Refusal					$4,666,361		
Retraction Clauses							
Size of Potential Loss			(1,395,900)	(1,443,361)	(1,492,435)	(1,543,178)	(1,595,646)
Probability of Occurring			50%	40%	30%	20%	10%
Value of Risk			(697,950)	(577,344)	(447,730)	(308,636)	(159,565)
Total Value of Retraction Clause					(2,191,225)		
Total Revenue		6,250,000	6,460,714	7,104,582	7,794,402	4,370,245	4,446,396
				$36,426,340			
Costs							
Fixed Costs		200,000	208,000	216,320	224,973	233,972	243,331
Variable Costs							
Units		750,000	830,000	918,600	1,016,732	562,715	622,920
Cost per Unit		3.00	2.79	2.59	2.41	2.24	2.09
Total Variable Costs		2,250,000	2,315,700	2,383,491	2,453,447	1,262,820	1,300,075
Total Costs		2,450,000	2,523,700	2,599,811	2,678,419	1,496,792	1,543,406
Pre-tax Earnings		3,800,000	3,937,014	4,504,771	5,115,983	2,873,453	2,902,991
Income Tax Rate		37%	37%	37%	37%	37%	37%
Net Income		$2,394,000	$2,480,319	$2,838,006	$3,223,069	$1,810,276	$1,828,884
Discount Rate							35%
Net Present Value							$5,963,964
Deposits							$125,000
Net Present Value (net of deposits)							$5,838,964

How a Contract Differs from a Patent

Contrary to popular sentiment, a patent does not grant the patentee a monopoly. Rather patents only grant the patentee the right to exclude anyone besides the patentee to practice the invention covered by the patent. A patent is nothing more than a license to sue and the patentee is allowed to sue anyone who infringes on his patent.

However, Richard Collier, partner at Collier & Basil P.C., in Princeton, New Jersey, points out that the contracts cannot be viewed as licenses to sue. This is true even if one party entered into the contract with fraudulent intent as fraud requires reliance on a lie. Also, there is less of a tripwire with contracts as compared to patents.

Any infringement of a patent is grounds for suit (although not necessary a prudent reason if the expected damages from infringement are less than litigation costs). Contracts, on the other hand, are governed by the Uniform Commercial Code's perfect tender rule. This perfect tender rule holds that, if the seller's delivery is less than perfect, (1) the buyer should tell the seller what the problem is and (2) the seller has the opportunity to cure the deficiency in a reasonable time.

Jersey, and (2) Francis J. Sullivan, partner at Hill Wallack LLP, in Newtown, Pennsylvania.

Based on interviews with seasoned contract lawyers, the author suggests that the model for calculating a discount rate for contracts is:

Discount Rate =
Risk-free Rate + Exposure to General Economic Factors + Exposure to Industry Economics + Exposure to Counterparty's Internal Factors + Impact of Legal Factors – Available Remedies

Risk-Free Rate

The risk-free rate is a fundamental underpinning of a cost of capital analysis. It is equivalent to the yield on the U.S. government debt with a duration that most closely matches the duration of the subject contract.

Exposure to Economic Factors

As recent years have demonstrated, all companies are at risk of being strongly affected by a deep recession. Companies that produce products for which their customers have an elastic demand (meaning they buy drastically less when income levels decrease) will fare worse than companies whose customers have an inelastic demand for their products.

Therefore, contracts covering customers who have elastic demand should have higher discount rates than contracts covering end users who have inelastic demand.

The formula for elasticity is change in demand divided by change in price (or income). The valuation analyst can review the extent to which demand was affected by past price increases or decreases in national income and project such trends on to future discount rates. Caution should be taken to avoid double discounting. Therefore, if the anticipated value of contractual income part of the model factored in a recession, then a smaller addition to the discount rate should be applied.

Exposure to Industry Economics

Entire industries are exposed to common competitive factors, legislation, regulation and government retribution. The more pressure that these externalities place on an industry's profits, the less economic it becomes to comply with the affected companies' contracts.

There are a host of competitive factors that can squeeze out an industry's profits, including increasing costs of materials or labor. Price wars—such as the incipient one between Amazon.com and Walmart in the book space—and a company viewing its competitors' primary market as a loss leader can rapidly devastate the profitability of an industry.

An entire industry can face a bleak future when its suppliers forward integrate or its customers backward integrate. A scandal rocking a leading industry player or the announcement of it incurring a massive loss can make it much more difficult for other industry players to secure necessary capital.

Technology can erase the rationale for an entire industry as happened to pagers when mobile phones became de rigour.

Structural issues that affect the profitability of an industry include: (1) low switching costs (the less expensive it is for customers to switch vendors, the more competition will ensue) and (2) the stakes of the existing players (the higher the stakes of the industry participants, the more fiercely they will compete).

Low barriers to entry—such as nominal capital requirements or nonexistent regulatory hurdles—are forerunners to more competitors. High barriers to exit accentuate inter-company rivalry. These barriers to entry occur when: (1) government regulations (e.g., prohibiting insurance companies to fold-up their operations) or (2) stranded costs (e.g., when a company has expensive machinery that it cannot liquidate) essentially force companies to remain in business.

Legislation and regulations—such as those requiring more environmental safeguards or those

facilitating the unionization of an industry's workforce—can raise the cost of doing business for entire industries.

When the government targets industries for higher income taxes and less freedom of operation—as has happened to health insurance, pharmaceutical, and oil companies in recent months—the profitability for the entire industry will be suppressed.

The valuation analyst may keep current with news relating to the industry under review so as to determine the likelihood of these kinds of events affecting the reviewed company's (Seating Sisters) and its counterparty's (in this case, Bicycle Brothers) ability to remain in compliance with their contracts.

Exposure to Counterparty's Internal Factors

A company that includes its contracts among its intangible assets is vulnerable to the prevailing internal dynamics occurring with its counterparties. Foremost among the factors to consider in this regard is the likelihood that the counterparty will breach or cease to honor the contract.

Companies are more likely to break their contracts under the following scenarios:

- The demands placed upon them by their shareholders.

  If a privately held company sells part of its equity to a private-equity or hedge fund, its new institutional investors will push management to deliver more dramatic earnings growth. This pressure may cause management to reevaluate its contracts.

- Number of internal influencers at the counterparty.

  Companies that have many access points for outside parties to influence changes in policy are more likely to break contracts than companies that have few decision makers. This is because it is easier for a special interest group to create internal pressure for a change in policy if the targeted counterparty has a large board of directors, foreign subsidiaries and franchisees than it is to effect change at a company whose sole shareholder makes all of the import decisions

  An example of how special interest groups can cause internal pressure is provided by the Greenpeace success in stopping Shell from dumping its Brent Spar oil rig in the North Sea in the mid-1990s. Even though the Shell UK operations were

responsible for Brent Spar, Greenpeace targeted Shell stations in Germany. This was because that nation's citizens were deemed to be more sympathetic to environmental causes. The result was that Shell stations in Germany suffered a 50 percent contraction in revenue. That caused the Shell German operations to pressure the Shell UK operations to reverse course on the Brent Spar matter.

- Peer companies' contracts have been broken without consequence.

  In our illustrative example, if other bicycle companies have broken their contracts with suppliers without any negative repercussions, then Bicycle Brothers may feel less risk and stigma with breaching its contracts with Seating Sisters. This conclusion is even more true when other customers have broken agreements with the subject company (i.e., with Seating Sisters).

- Better alternatives become available.

  If a better product or a product of comparable quality priced more competitively becomes available, the counterparty will be more inclined to find a reason to terminate the contract.

- Reduced ability to perform.

  If Seating Sisters was to deliver faulty seats to Bicycle Brothers, Seating Sisters could be in breach of its contract. However, even when a vendor fails to perform to expectations in one dimension of its relationship with its customer, that lapse can be used as a justification to break a different contract.

  Mr. Sullivan explains that companies that cannot adhere to "meet or release" contract provisions are at risk of losing their contracts. Such meet or release clauses typically hold that suppliers (Seating

Sisters) should either meet their customer's (Bicycle Brothers) volume and/or price demands or they should release their customers from their contracts.

- The subject company has a known no litigation policy.

  Some managements have publicly stated that they are in the (bicycle seating) business, not in the litigation business. The articulation of this policy disinhibits counterparties (e.g., Bicycle Brothers) from breaking their contracts.

- Vendor's financial dependence on the contract

  Customers who realize that their vendors are dependent on a contract are more likely to believe that they can breach various contract provisions without penalty. This situation could arise if the customer realizes (1) that it is one of the vendor's largest customers, (2) that the vendor would be in breach of its loan covenants if it lost its contract, or (3) that the vendor's shareholders could move to replace management if it lost the contract in question.

- Disparity in size.

  When the customer is much larger than its vendor, the customer is more likely to breach the contract. This is because it will believe that the vendor has no recourse. One factor in this decision is that the vendor would not be able afford to defend itself against its much larger customer in litigation.

- New management at the counterparty's company.

  New management teams often want to shake things up. Foremost among the items to be shaken up are contracts with vendors. Holders of contracts (e.g., Seating Sisters) are especially vulnerable if the new management team (e.g., Bicycle Brothers) has worked with competitors to the contract holder for an extended period of time.

- Likelihood of the counterparty becoming acquired.

  If Bicycle Brothers was to be acquired, Seating Sisters would be confronted with a larger possibility of having its contract abrogated. This is due to the new management risk factors discussed above, as well as the possibility that the acquiring company may wish to (1) consolidate its bicycle making operations, (2) terminate its bicycle making operations, or (3) renegotiate with Seating Sisters so as to exercise its enhanced bargaining power resulting from its larger scale.

- Reputation of the counterparty.

  Counterparties that have a reputation for entering into contracts with no intention of honoring them carry tremendous risks for companies that consider their contracts to be intangible assets.

The following scenarios would indicate that a counterparty is less likely to break contracts with its vendors:

- Unacceptable concentration of suppliers.

  A dominant customer may not wish to injure its vendor (even if it could do so without triggering litigation) when doing so could result in remaining potential vendors having excessive power over the customer.

- Proprietary technology.

  Bicycle Brothers is less likely to break its contract with Seating Sisters if Seating Sisters has proprietary technology.

- Customers associate value with the supplier's products.

  If a supplier advertises its components and creates demand for them, it then becomes more difficult for a customer to break an agreement and use another vendor. For instance, when Intel created quite a bit of demand for its semiconductors via its Intel Inside advertising campaign, the use of competing semiconductors by computer manufacturers were perceived to be using lower quality processors.

- Cross ownership.

  Contracts are less likely to be broken when cross ownership exists between customers and vendors. The same is true when there is overlap among the companies' boards of directors.

- Relatively small component.

  Bicycle Brothers would be less likely to break its contract with Seating Sisters if such contract represented a small percentage of its purchased parts. Companies generally attempt to enhance their profitability rather than damage their competitors (let alone suppliers). And, there is less upside to renegotiating small contracts.

- Length and integration of business relationship.

  A customer would be less inclined to breach a contract with a long-term vendor,

especially when the two companies depend on one another for a variety of products and services.

- Position in the customer's value chain.
  Parts that are crucial for enabling the sale of end products are less vulnerable to contract renegotiation. For instance, a brake manufacturer would typically have more leverage over an auto maker than a producer of coffee cup holders. Companies that manufacture parts that are installed at the beginning of an assembly process are less vulnerable to contract breaches than parts that are manufactured at the end of assembly lines.
- Inability to accumulate inventory.
  Customers that have difficulty accumulating inventory produced by a particular vendor are less likely to violate their agreements with such vendors. Included in the characteristics of inability to accumulate inventory are (1) services (such as air travel and consulting), (2) products that have short shelf lives, and (3) products that are expensive to warehouse and insure.

Legal Issues

A host of legal issues can affect the probability that a contract will be violated or terminated. Among the metrics that can be used to estimate such probabilities are the following:

- Construction of the contract.
  Typically, contracts that are shorter (in terms of word or page count) reflect a long-standing business relationship between the two signatories. On the other hand, longer contracts may indicate a lack of fundamental trust between the parties and are more exposed to human error in drafting.

  Therefore, as a generality, shorter contracts (relative to contracts covering similar situations) are deserving of lower discount rates than longer contracts. Similarly, highly specific contracts are easier to break. This is because there are more conditions that can be violated.

  In the author's experience, older contracts are more susceptible to being violated as the players that negotiated the original contract move on (and no longer administer it) and as economic realities deviate from the expectations underpinning the contract.
- Who drafted the contract.
  Law firms that have an expertise in writing similar contracts and large law firms

that bear the accoutrements of success signal that their contracts are more difficult to violate. Lawyers who have represented the client—or similar clients in the same industry—for an extended period of time are more likely to draft contracts in light of possible points of contention.

If lawyers are integrated into initial rounds of business discussions, their comments can be more congruously woven into the agreements as opposed to when business people reach an agreement and then hand it off to lawyers to draft accompanying contracts.

- Governing jurisdiction.
  The jurisdiction in which contract litigation is likely to be heard has an effect on the propensity of a counterparty to violate a contract. If contract disputes between Bicycle Brothers and Seating Sisters were to be heard in Seating Sisters' home city, juries may be more sympathetic towards Seating Sisters. Therefore, Bicycle Brothers may be more reluctant to violate its contract with Seating Sisters.

  However, if a judge hears the same litigation in a district where neither of the litigants had a major presence, Bicycle Brothers may believe that it has a better chance of convincing the judge of the merits of its actions. As Mr. Feinberg points out, it is important to ascertain which party (if either) has the right to select venue and whether a judge or jury will rule on the dispute.
- Termination features.
  Contracts that allow one party to terminate the agreement merely by notifying the other party—say 90 days beforehand—have a higher risk of expiring prematurely than

contracts that have more onerous termination provisions.

- Potential damages.

  If there is a risk that a party that violates a contract will be liable for treble damages, there is less risk in a counterparty breaking the contract. Another factor that affects the likelihood that a contract will be broken is the ability to cause a class action.

- Personal guarantees and insurability.

  Contracts that require personal guarantees by principals of one party are less likely to be violated by that party. Contracts that are covered by insurance policies could be more likely to be violated by the party that has obtained the insurance because of adverse selection and moral hazard issues.

Remedies

The incidence of contracts being violated and of the associated costs are mitigated when there are effective remedies for handling violated contracts. Among these remedies are:

- Ability to transfer the contract.

  The easier it is to transfer the contract to another supplier, the greater should be the negative discount rate factor.

- Reputation of contract holder.

  Contract holders that have earned reputations for their willingness to mount vigorous and sustained litigation against business partners that violate their contracts often benefit from the shield of deterrence to future violations of their contracts.

- Politicization of potential litigation.

  While larger companies may feel freer to break their contracts with small suppliers, large companies are quite sensitive to the media attention that may accompany such litigation. A senior executive of Ford Motor told the author that his company takes measures not to attract media attention.

  Larger companies have more to lose from media attention as they have more customers, are more exposed to regulators, and have shareholders that would hold management accountable for attracting such media attention.

- Game theory remedies.

  If Seating Sisters had side agreements that—in the event that Bicycle Brothers violated its contract—enabled it to invoke remedies based on game theory, there would be less risk of its contracts being violated.

  Such permutations of game theory could include:

  1. Upon signing the contract, both parties could agree that each quarter that Bicycle Brothers remitted payment as stipulated by the contract, Seating Sisters would donate a small percentage of the proceeds to a charity of importance to Bicycle Brothers.

     A violation of the contract would result in a cessation of such charitable donations. Seating Sisters would have the right to disclose the reason for the cessation of donations.
  2. A violation of their agreement by Bicycle Brothers would allow Seating Sisters to publish a letter of resignation by Bicycle Brothers from its trade associations.

     Such letter would have been previously signed by Bicycle Brothers and would declare that Bicycle Brothers did not uphold business practices acceptable to the trade associations.

The total discount rate used in the illustrative example is estimated to be 35 percent (as presented in Exhibit 3).

Value of Ancillary Economic Benefits

Contracts represent value to a business beyond the discounted expected earnings they are projected to deliver. Securing customers and vendors, as evidenced by executing contracts, enhances the predictability of sales and delivery of supplies. This predictability reduces volatility in earnings, which is rewarded by the financial community.

Contracts lend credibility to the signatories and buttress the reputations of the firms involved. This reputation enhancement can carry over to many facets of the signatories' businesses.

The following discussion summarizes the ancillary economic benefits that result from winning contracts:

- Access to capital.

  Companies that can demonstrate to investors and creditors that they have binding contracts have an advantage in securing capital. This is an important consideration as the availability of capital and credit is often the difference between a company surviving and perishing.

Exhibit 3
Illustrative Example
Discount Rate Estimation

	Discount Rate	Maximum Points
RISK-FREE RATE		
Duration of contract		
Rate of US government debt for similiar period of time		
	5%	15%
BASIC ECONOMIC FACTORS		
Risk of a recession over the term of the contract	2%	
Expected number of contract years of recession	2%	
Expected severity of recession	2%	
Elasticity of demand for products	1%	
	7%	20%
INDUSTRY ECONOMICS		
Competitive Factors:		
Barriers to entry	1%	
Barriers to exit	0%	
Switching costs	0%	
Stakes of rivals	2%	
Others	1%	
	4%	11%
Adverse Legislation:		
Likelihood	1%	
Estimated severity	1%	
	2%	7%
Adverse Regulation:		
Likelihood	1%	
Estimated severity	1%	
	2%	7%
	8%	25%
INTERNAL FACTORS		
Shareholder risk	5%	
Influencers risk	5%	
History of breaking contracts	5%	
Better alternatives	5%	
Ability to perform	3%	
Litigaiton policy (contract holder)	2%	
Contract dependence	5%	
Size disparity	3%	
New management at counterparty	4%	
Acquisitioin of counterparty	5%	
Counterparty's reputation	4%	
	46%	
Risk of supplier concentration	4%	
Proprietary technology	4%	
Value of suppliers products	4%	
Cross Ownerhsip	4%	
Component percentage	4%	
Stability of relationships	4%	
Position in value chain	4%	
Inability to accumulate inventory	4%	
	32%	
	14%	35%

Discount Factors

Premium Factors

	Discount Rate	Maximum Points
LEGAL ISSUES		
Contract construction	1%	
Contract drafting	1%	
Governing jurisdictions	2%	
Termination features	1%	
Potential damages	1%	
Personal guarantees	1%	
Insurability	0%	
	7%	20%
REMEDIES		
Contract transferability	-2%	
Contract holder reputation	-1%	
Politicization of litigaton	0%	
Game theory remedies	-3%	
	-6%	-15%
Total Discount Rate	**35%**	**100%**

Note: This analysis weights the economic factors much more heavily than the legal factors, based on the theory that economics trumps legality. When a contract becomes uneconomic, legal justifications for terminating it will be discovered.

- Elevated market capitalization.

  The announcement of an important contract win can cause shares of a publicly traded company to spike upwards, elevating the contract winner's market capitalization.

  One method for determining the extent of any market capitalization enhancement resulting from a contract win is to take the average share price 20 days prior to the contract win and subtract from that amount the average price of the stock five days after the announcement of the contract. This difference should be multiplied by the number of shares outstanding.

- New accounts wins.

  Winning contracts from reputable industry players validates the contract winner and makes it easier to win future accounts. This is especially true when the initial clients agree to serve as reference accounts for their vendors.

  Winning important contracts can also give existing customers the confidence to purchase other products from the contract winner, thereby providing the company with more cross-sell opportunities.

- Retention of key personnel.

  A company that is making progress in executing its business plan is not only attractive to investors and customers, but also to its own employees.

  Companies that win accounts also give their employees further reasons to remain with the company. Therefore, contract wins can reduce the turnover of valued employees.

- Enhance operating efficiency.

  Securing business from customers enables vendors to operate their factories and other assets at higher utilization levels. These higher utilization levels, in turn, reduce the costs of unit production. This reduced cost of production enables the firm to be more price competitive.

  In the illustrative example, the value of ancillary economic benefits was calculated to be $2,472,610 (see Exhibit 4).

Recoveries

In situations where contracts are broken, all is not always lost. Recoveries in the form of collecting business interruption insurance proceeds, settlements (minus lawyers fees), and the proceeds from affected liquidated inventories should be added back to the value of the contract.

The valuation analyst may derive these values by multiplying pretax earnings by the product of risk of contract termination, percent of contract expected to be lost if contract is terminated and the percentage of contract recovery.

In the illustrative example, total recoveries are projected to be $201,850 (see Exhibit 5).

Transaction Fees

The value of the contract should be reduced by the amount expended on outside professionals (usually, lawyers and consultants) for their services in connection with consummating the transaction.

In the illustrative example, Seating Sisters incurred transactions costs of $235,000 in the first year of the contract and nominal $3,000 costs in the subsequent years. The net present value of these transaction fees in the illustrative example is $241,660 (see Exhibit 6).

Total Contract Intangible Asset Value

In conclusion, the valuation analyst may calculate the total contract value by applying the following formula:

Contract Value =
Deposits + ((Anticipated Value of Contractual Income – Deposits) × Discount Rate) + Value of Ancillary Economic Benefits + (Recoveries × Discount Rate) – Transactions Costs

The total value of the illustrative contract in the illustrative example is $8,396,763 (see Exhibit 7).

Summary and Conclusion

Intangible asset valuation analysts will typically apply professional judgment to the unique circumstances that they are confronted with when valuing contracts. This discussion presents a de novo income approach method for the valuation of commercial contracts. The de novo valuation methodology introduced above presents the author's guidance with respect to the valuation of commercial contracts.

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Exhibit 4
Illustrative Example
Value of Ancillary Economic Benefits

Projection Period	2010E	2011E	2012E	2013E	2014E	2015E
New Account Wins Due to the Contract						
Bidding for new business	$ 20,000,000	$ 25,000,000	$ 32,000,000	$ 29,000,000	$ 26,000,000	$ 3,000,000
Average/historical win rate	28%	28%	28%	28%	28%	28%
Value of expected contract wins	5,600,000	7,000,000	8,960,000	8,120,000	7,280,000	840000%
Enhanced win rate	7%	7%	7%	7%	7%	7%
Expected enhanced contract wins	392,000	490,000	627,200	568,400	509,600	58,800
Net Present Value of the Expected Enhanced Contract Wins						**$ 1,108,641**
Value of Enhanced Retention of Key Employees						
Employee count	275	290	320	325	330	345
Average annual turnover/valued employees (%)	12%	12%	12%	10%	10%	15%
Average annual turnover/valued employees	33	34.8	38.4	32.5	33	51.8
Sales people retained because of technology (%)	10%	10%	10%	10%	10%	10%
Sales people retained because of technology	3.3	3.5	3.8	3.3	3.3	5.2
Cost of Replacing Sales People						
Recruiters commissions	30,000	30,600	31,212	31,836	32,473	33,122
Upfront bonus	15,000	15,300	15,606	15,918	16,236	16,561
Training costs	20,000	20,400	20,808	21,224	21,649	22,082
Interruption in customer service	20,000	20,400	20,808	21,224	21,649	22,082
Total costs of replacing salesperson	85,000	86,700	88,434	90,202	92,007	93,847
Annual Value of Retention of Key Employees	280,500	301,716	339,587	293,159	303,622	485,658
Net Present Value of Enhanced Retention of Key Employees						**$ 747,552**
Value of Enhanced Access to Capital						
Total debt load	4,000,000	4,250,000	4,500,000	5,000,000	5,250,000	5,500,000
Reduction in interest costs	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%
Total interest cost savings	8,000	8,500	9,000	10,000	10,500	11,000
Net Present Value of Reduced Interest Costs Due to Enhanced Access to Credit						**$ 21,417**

Enhanced Market Capitalization		
Average price of stock	$	27.35
20 trading day before contract		
Average price of stock	$	28.05
5 trading days after contract		
Price difference due to contract	$	0.70
Number of shares outstanding		85,000,000
Market Capitalization Enhancement		**$ 59,500,000**
Discount factor		99%
Net Market Cap Enhancement		**$ 595,000**

Total Value of Ancillary Economic Benefits **$ 2,472,610**

Exhibit 5
Illustrative Example
Recovery in the Event of a Contract Violation

Projection Period		2010E	2011E	2012E	2013E	2014E	2015E
Pre-tax Earnings		$ 3,800,000	$ 3,937,014	$ 4,504,771	$ 5,115,983	$ 2,873,453	$ 2,902,991
Risk of Contract Termination							
Discount rate	35%						
Risk-free rate	5%						
Risk of Contract Termination	30%	30%	30%	30%	30%	30%	30%
Percent of Contracts Expected to be Lost		10%	14%	18%	22%	26%	30%
Value of Lost Contracts		$ 114,000	$ 165,355	$ 243,258	$ 337,655	$ 224,129	$ 261,269
Percent of Contract Recovery							
Liquidation of Inventory		5%	5%	5%	5%	5%	5%
Insurance Proceeds		5%	5%	5%	5%	5%	5%
Settlements		5%	5%	5%	5%	5%	5%
Percent of Contract Recovery		15%	15%	15%	15%	15%	15%
Annual Recovery if Contracts are Violated		17,100	24,803	36,489	50,648	33,619	39,190
Total Recovery Potential							$ 201,850

Exhibit 6
Illustrative Example
Transaction Fees

Projection Period	2010E	2011E	2012E	2013E	2014E	2015E
Transaction Fees	$ 235,000	$ 3,000	$ 3,000	$ 3,000	$ 3,000	$ 3,000
Discount Rate						35%
Net Present Value of Transaction Costs						$ 241,660

Exhibit 7
Illustrative Example
Total Contract Value Summary

Deposits	$ 125,000
Anticipated Value of Contractual Income	5,838,964
Value of Ancillary Economic Benefits	2,472,610
Recoveries	201,850
Transaction Costs	241,660
Total Contract Value	$ 8,396,763