Incwert Valuation Chronicles
Series 5 I 2020

Purchase Price Allocation (“PPA”) study in the Banking and Insurance sector

Aiming at readiness for the upcoming Ind AS implementation in the Banking and Insurance sector by drawing references from the US market

July 2020

Foreword

The RBI had issued a circular in February 2016 requiring banks to implement Indian Accounting Standards (Ind AS) and prepare standalone and consolidated Ind AS financial statements with effect from 1 April 2018. However, the RBI in its press release issued on 5 April 2018 deferred the applicability of Ind AS by one year (i.e. 1 April 2019) for Scheduled Commercial Banks. Further, RBI in a circular issued on 22 March 2019 deferred the implementation of Ind AS till further notice.

Similarly, implementation of Ind AS in the Insurance sector has also been deferred, and IRDAI shall decide the date of application after the finalisation of IFRS 17 by IASB (*IRDAI/F&A/CIR/ACTS/023/01/2020 Date: 21 January 2020*).

While the postponement has provided some relief to the Banks and Insurance companies, we considered it to be appropriate to utilise this temporary deferral to analyse select business combinations that have occurred in the banking and insurance sector in the USA up to 31 December 2019.

Ind AS driven PPA disclosures (Ind AS 103) have a lesser history in the BFSI sector driven by a smaller number of business combination transactions in this sector. We, therefore, believe that it might be a good idea to explore the more mature US market for drawing inferences that can provide guiding sticks for deal reporting in India.

We hope you find the results of our study of interest and value.

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Key observations:

1. **45-47% of the purchase consideration is towards goodwill**
2. **Allocation of consideration to identified intangible assets in the insurance sector (41%) is significantly higher than the banking sector (7%)**
3. **Core deposit accounts and customer relationships constitute the largest identified intangibles in the banking and insurance sectors respectively**
4. **Number of intangibles identified was mostly 1 in the banking sector and 2-3 in the insurance sector**

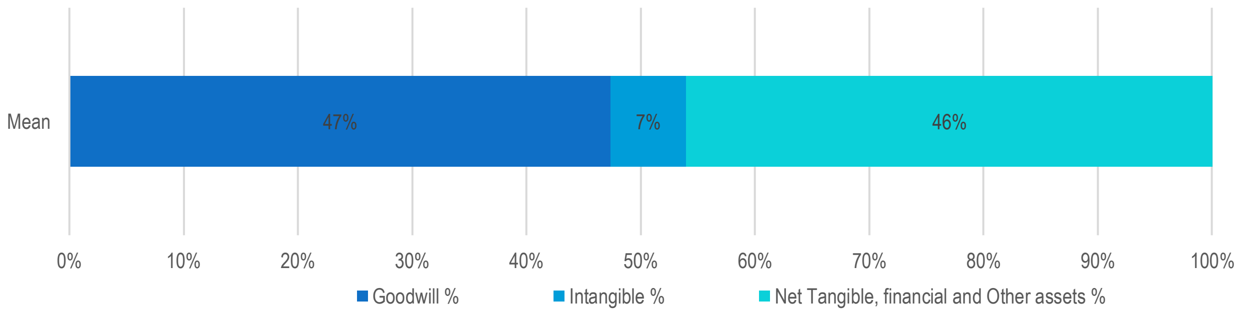
Note – 1) Purchase price allocation is an application of goodwill accounting after the transaction has occurred, in which a company (acquirer) while purchasing another company (target), allocates the purchase price into various acquired assets and liabilities assumed.

Around 45-47% of the purchase consideration is towards goodwill in both, banking and insurance sectors. However, allocation of identified intangible assets in the insurance sector (41%) is significantly higher than the banking sector (7%)

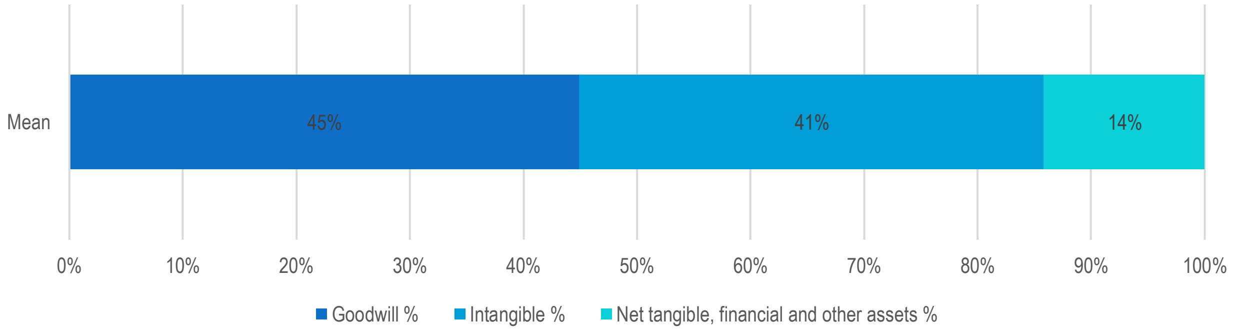
In the US banking sector, we noted that 47% of the purchase consideration is allocated towards goodwill, 7% is allocated towards identified intangible assets and balance 46% towards identified tangible assets in the banking industry.

In the US insurance sector, 45% of the purchase consideration is allocated towards goodwill, 41% is allocated towards identified intangible assets and balance 14% towards tangible assets.

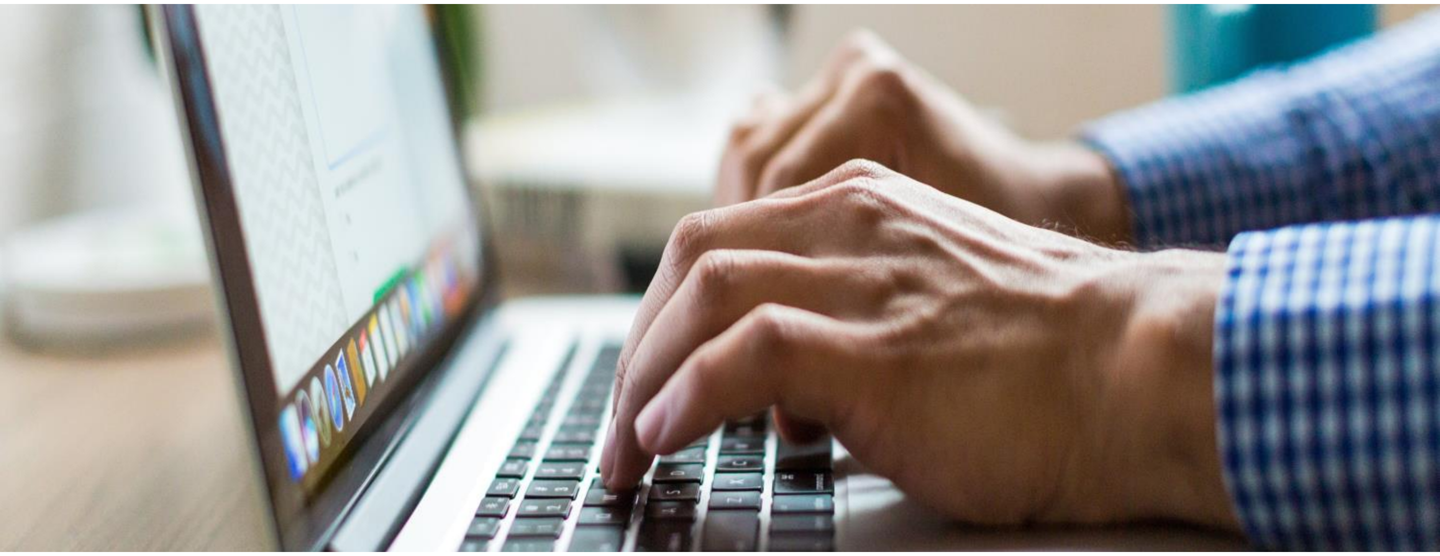
Mean allocation of purchase consideration of US Banking sector



Mean allocation of purchase consideration in US Insurance sector

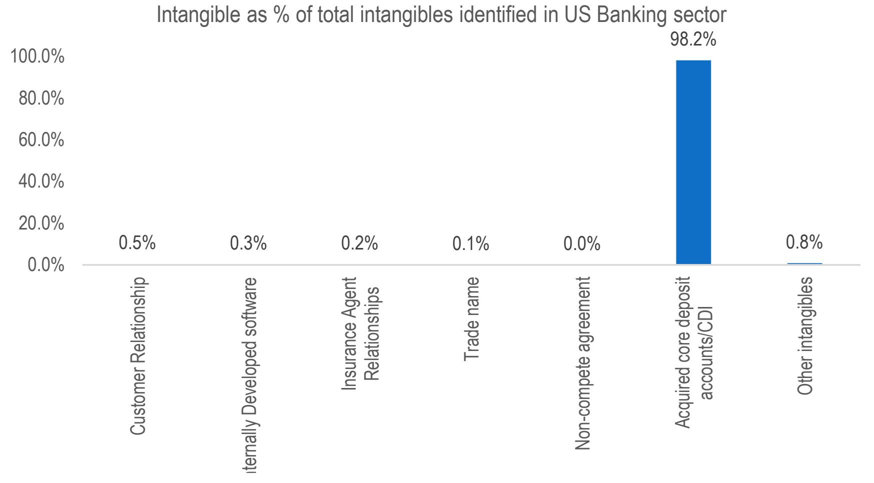


Note: Sample size of 50 business combination occurred in banking and insurance sector in USA up to 31 December 2019 have been considered.
Source: Company filings, publicly available news articles and Incwert analysis

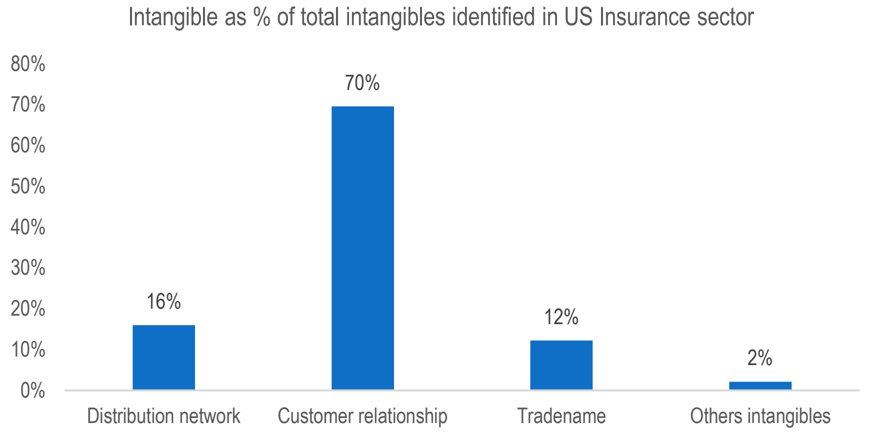


‘Core deposit accounts’ (98%) and customer relationships (70%) constitute the largest portion of identified intangible assets in the US banking and insurance sectors respectively

Core deposit accounts/CDI constitute the largest portion (98%) of identified intangibles in the banking sector of the US. It is recognized when a bank has a well-balanced deposit base comprised of funds associated with long term customer relationships.



Customer relationship constitutes the largest portion (70%) of identified intangibles in the insurance sector of the US. It is the fundamental value driver of an insurance company which is basically the in-force contracts already existing in the business.

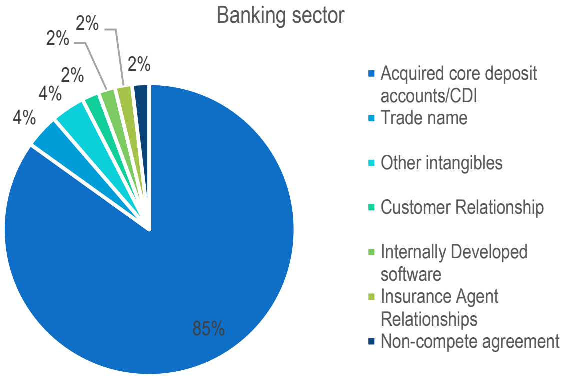


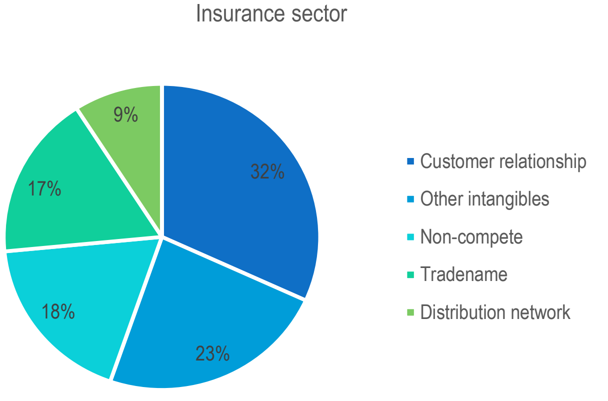
Note: 1. Sample size of 50 business combination occurred in banking and insurance sector in USA up to 31 December 2019 have been considered.
2. Other intangibles in Insurance sector includes IPRs, Leases, licenses and other intangibles.

Source: Company filings, publicly available news articles and Incwert analysis

Key findings

1 Frequency of intangibles identified

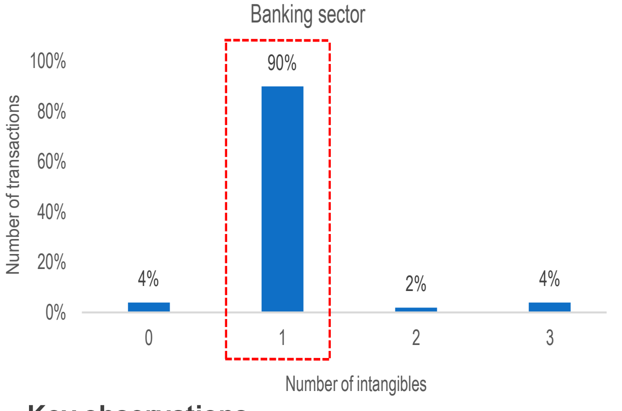


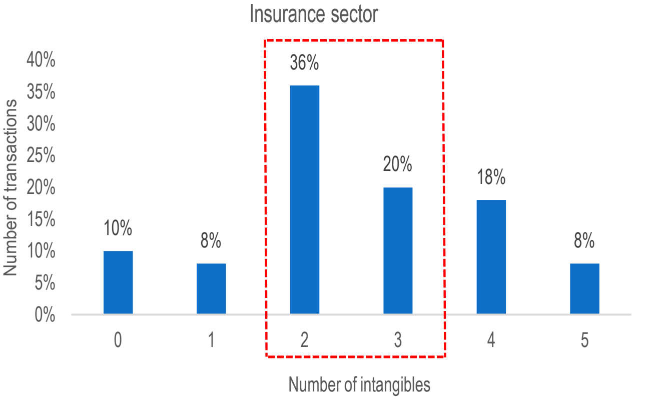


Key observations

- In the banking sector, core deposit account/CDI is the most often identified intangible asset with the same being observed in 85% of the transactions.
- In the insurance sector, the occurrence rate of customer-related intangible assets is 33% followed by 22% for other intangibles (including IPRs, leases, licenses)

2 Number of intangibles identified



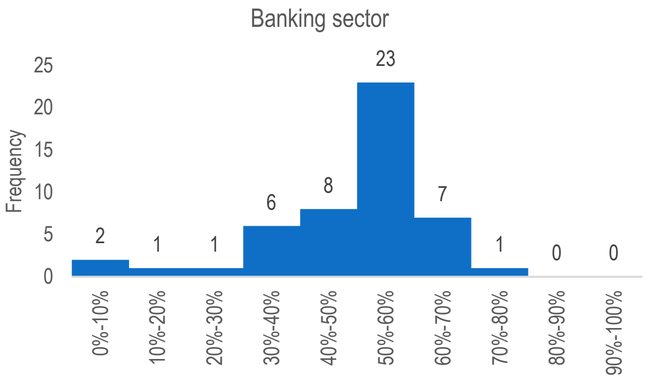


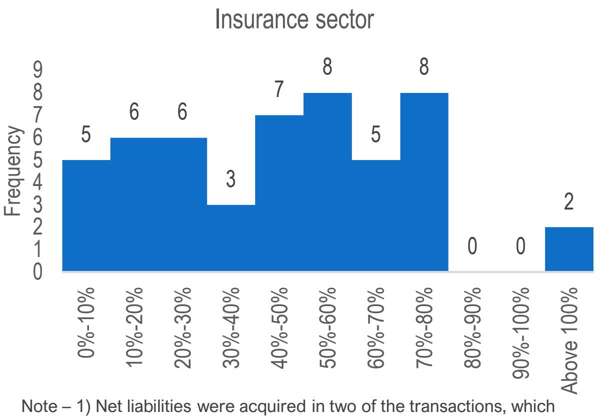
Key observations

- In the banking sector, out of a total of 50 transactions, 90% of transactions identified only 1 intangible asset i.e. core deposit account/CDI.
- In the insurance sector, 56% of transactions identified 2-3 intangible assets in which key intangibles are customer relationships and distribution network.

Key findings

3 Goodwill as % of purchase consideration





Note – 1) Net liabilities were acquired in two of the transactions, which resulted in a goodwill in excess of the purchase consideration.

Key observations

- In the banking sector, out of 50 transactions analysed, goodwill is mostly constituting 50%-60% of overall purchase consideration (i.e. 23 transactions)
- In the insurance sector, goodwill ranges from 0%-80% and in a couple of the transactions goodwill is more than the purchase consideration paid.

Understanding the study…

1 Methodology

Overview of our methodology

- For the banking sector, we have analysed top 50 business combinations that occurred in the USA during the past 2 years ending 31 December 2019. For certain transactions, only the total value was disclosed for all the intangibles recognised. For such cases, the value of intangibles was assigned to core deposit intangibles.

- For the Insurance sector, the business combinations that occurred during the past 10 years ending 31 December 2019 were analysed. The transactions with a purchase price exceeding USD 25 million were considered. A total number of 50 transactions were identified where adequate information about PPA was disclosed. Appropriate assumptions were considered with regard to intangibles where the full information was not disclosed.

2 Knowledge refresher

What is purchase price allocation?

Purchase price allocation can be defined as a practice where an acquirer allocates the purchase price into the assets and liabilities of target company acquired in the transaction. Goodwill is essentially the residual value of purchase consideration less the fair value of assets and liabilities.

While it is usual to allocate the purchase price, for the purpose of BFSI sector, analysis has been based on purchase consideration. Examples of potential forms of consideration include cash, other assets, contingent consideration, common or preferred stocks, options, etc.

3 Unique sector

Why is BFSI sector unique?

Financial service firms have much in common with non-financial service firms. They attempt to be as profitable as they can, must worry about competition and want to grow rapidly over time. But there are a few points which make them unique from non-financial service firms:

- Capital of non-financial service firm includes both debt and equity. But with financial service firm, debt seems to take a different connotation. Rather than treating debt as a source of capital, most financial firm seems to treat it as a raw material. Therefore, capital at financial service firms seems to be more narrowly defined as including only equity capital.

- Financial service firms are heavily regulated all over the world, though the extent of the regulations varies from country to country.

Understanding the study…

4

Regulatory requirement

Standards applicable

Ind AS 103	ASC 805
• Under Ind AS 103, an acquirer must recognise any assets acquired and liabilities assumed, and any non-controlling interest in the acquiree at the acquisition date, measured at fair value as of that date. • FV is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at a measurement date. • Recognize and measure the goodwill acquired in the business combination or a gain from a bargain purchase.	• ASC 805 requires that all identifiable tangible and intangible assets acquired be assigned a portion of the purchase price based on their fair values (FV). • FV is defined as the amount that would be exchanged in the sale of an asset or transfer of a liability in an orderly transaction between market participants at a specified date. • For accounting purpose, goodwill is considered a residual amount. In some cases, an acquirer may make bargain purchase, an excess gain recognised on the acquisition date.

Key observation: Accounting treatment for business combinations as per Ind AS 103 and ASC 805 are similar.

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Convergence

AS 14 "Accounting for amalgamation"- Need for convergence to Ind AS 103- "Business combination

Ind AS convergence has led to transformation in the Business combination reporting. As and when Ind AS is made effective for commercial banks and Insurance companies, the banking and insurance companies shall have to do the accounting for all business combinations using the acquisition method which requires fair value accounting of assets and liabilities of the acquiree at the time of acquisition, leaving goodwill as the residual balance.

Since AS-14 does not address the accounting needs in case of such transactions, Ind AS 103 has been introduced to cover a wider range of transactions (including slump sale, demergers, etc.) to bring uniformity between the industry practices and accounting treatments.

A key difference between Ind AS 103 and AS 14 is the way Goodwill is being treated. Under Ind AS 103, any Goodwill arising out of Business Combinations is tested for impairment annually instead of being amortised over five years. Ind AS 103 has also introduced new terms and concepts such as reverse acquisitions, bargain purchase and recording of contingent considerations, among others.

Understanding the study…

6

Intangibles identified

Types of intangible assets identified

Following intangibles can be identified during a business combination:

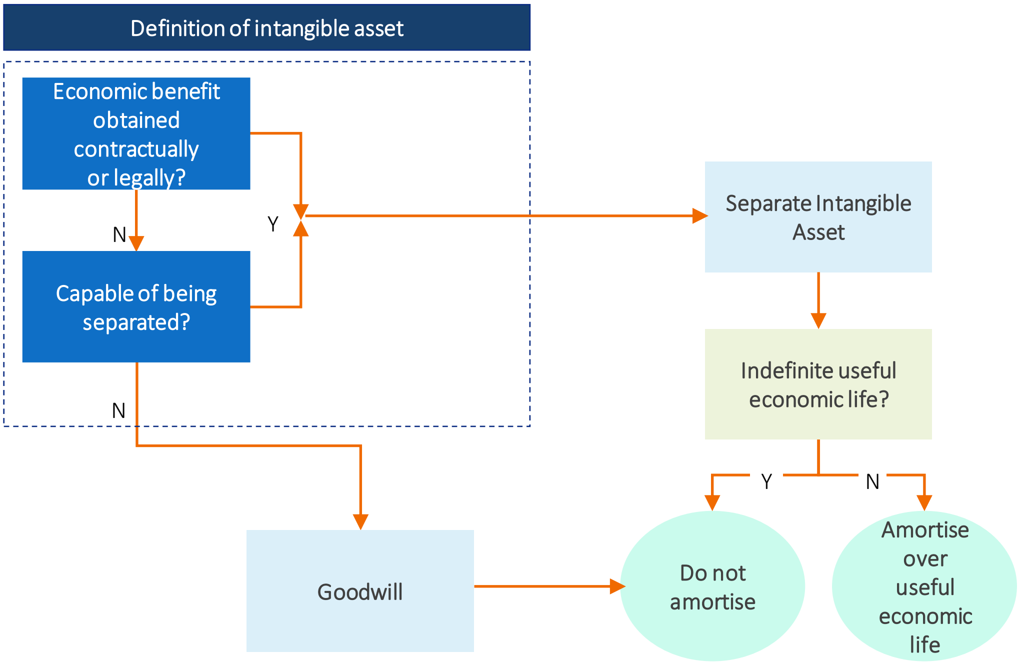
- Marketing-related intangible assets such as trademark, trade names, service marks, collective marks, certification marks, internet domain names
- Customer related intangible assets such as customer lists, order or production backlog, customer contracts and the related customer relationships, non-contractual customer relationships
- Artistic-related intangible assets
- Contract-based intangible assets such as servicing contracts, employment contract, use rights
- Technology based intangible assets such as computer software and mask works, databases including title plants, trade secrets (e.g., secret formula, processes etc)

7

Recognition

Identifiable vs. unidentifiable intangible assets: Ind AS 103, Business Combination

According to Ind AS 103, the acquiring enterprise is required to identify and account for identifiable intangible assets acquired in a business combination apart from goodwill if the asset arises from contractual or other legal rights or is capable of being separated or divided from the acquired enterprise either individually or with a related contract, asset or liability



Reference | Incwert Publications

Reference Material:

- Company filings and other publicly available information
- SEC US
- Incwert analysis

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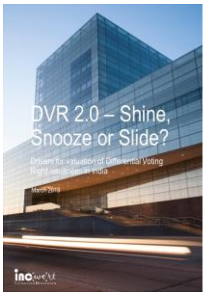

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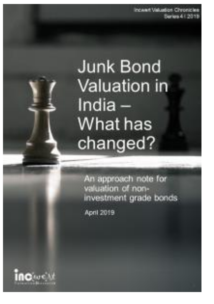

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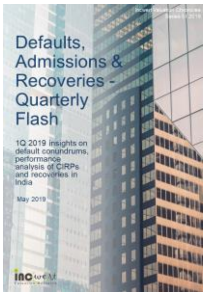

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Management | Advisory Board

Sunit Khandelwal
Director

Sunit has worked across a range of sectors such as Infrastructure, real estate, FMCG, retail, engineering, clean energy, healthcare, IT/ ITeS, and other manufacturing industries.

Qualifications:
Chartered Accountant (ICAI)
B.Com (Hon.) – St. Xavier's College
Registered Valuer with IBBI

Sunit has an overall experience of over 13 years in valuation advisory, transaction advisory and M&A advisory.

As a valuation professional, Sunit has undertaken valuation of businesses for transactions, fund raising, strategic decision making, and corporate restructuring. He has also undertaken valuation of intangible assets, option valuation, litigation support, private equity portfolio valuation and valuation for reporting purposes such as purchase price allocation and impairment test under IFRS and Indian GAAP.

In past he has worked with KPMG India (as Associate Director), BDO, Grant Thornton, KPMG UK, and DBDBS a boutique M&A advisory firm.

Sunit is also an active speaker on valuation at National Institute of Finance Management (NIFM).

Punit Khandelwal
Director

Punit has worked across leveraged loans, distressed debt, insolvency/ bankruptcy situations and high-yield asset classes.

Qualifications:
Chartered Accountant (ICAI)
Chartered Financial Analyst (ICFAI)
CFA Level 2 (US)
MS in Finance (ICFAI)
B.Com (Hons.) – St Xavier's College
Registered Valuer with IBBI

Punit brings with him 15 years of experience in sell-side and buy-side advisory across equity and fixed income. He has worked on several bespoke valuations and lent research support to dozens of asset managers/investment bankers/brokers/consulting firms across the globe.

In the fixed income segment, he worked as a fundamental analyst across the capital structure: leveraged loans, distressed debt, insolvency/bankruptcy situations and high-yield asset classes. He has also helped sell-side & consulting firms increase their market presence by coming up with thematic and white label papers.

He started his career as an analyst with Zacks Investment Research & then was a part of a UK based CLO manager's research team. Then he moved on to set up research practices for couple of startups before moving onto become Global Head of Research at one of the largest BPO/KPO in the world and then finally co-founded Incwert.

He won 40 under 40 Alternative Professionals Awards 2020 by AIWMI

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