

PURCHASE PRICE ALLOCATION

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This presentation deals with the allocation of the purchase price of an acquisition between the assets acquired (financial, physical & intangible) and the liabilities assumed, on the basis of their relative Fair Values. It covers the application of the 2001 revision of CICA Handbook Section 1581 to Lamb Industries Inc. ("Lamb"). On August 17, 2001 (the "Acquisition Date"), fifteen days before its year-end, Lamb was acquired by Diamond Enterprises Inc. The consideration was \$8 million cash and 300,000 shares at \$9.87 each, for a total of \$10,960,000.

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LAMB INDUSTRIES

Lamb, located in Southern Ontario, was formed in 1986 to supply specialized equipment to the food processing industry; its markets are worldwide, with installations in over 30 countries. They are served from offices in Canada, Britain, Germany, Tennessee and The Peoples' Republic of China. Lamb is a niche supplier and a comparatively small worldwide participant, with about 3% market share.

Operating Record

Sales were 53% in Europe, the Middle East & Africa, 15% in Asia and 32% in North America. From fiscal 1997 to 2000, revenues declined by 20%, due to the loss of a major customer; in 2001 they improved to the 1998 level. The results for the last five completed fiscal years are set out below:

Year to August 31	1997	1998	1999	2000	2001
REVENUES	24,236	21,708	19,840	19,468	21,774
GROSS PROFIT'	11,130	10,766	10,128	10,572	11,530
EXPENSES					
Distribution	1,792	1,524	1,454	1,596	1,616
R&D	2,036	1,854	1,450	1,628	1,938
Administration	5,872	6,544	5,116	5,818	5,926
Interest-net	228	146	78	4	12
	<u>9,928</u>	<u>10,068</u>	<u>8,098</u>	<u>9,046</u>	<u>9,492</u>
PPE-TAX PROFIT	1,202	700	2,030	1,526	2,038
INCOME TAX	477	260	830	616	838
NET INCOME	<u>725</u>	<u>440</u>	<u>1,200</u>	<u>910</u>	<u>1,200</u>
MARGINS					
Gross	45.8%	49.6%	51.0%	54.3%	53.0%
Distribution	7.4%	7.0%	7.3%	8.2%	7.4%
R&D	8.4%	8.5%	7.3%	8.4%	8.9%
Administration	24.2%	30.2%	25.8%	29.9%	27.2%
Interest--net	0.9%	0.7%	0.4%	0.0%	0.0%
Pre-tax	4.9%	3.2%	10.2%	7.8%	9.5%

After 1997, as new and enhanced products were introduced, gross margins improved. Over the period, Management reduced R&D expenses in line with falling sales to ensure an increase in profits and paid dividends of \$1,492,000.

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Balance Sheet

At August 17, 2001, the Acquisition Date, Lamb's Balance Sheet was:

	\$'000
Assets	
Cash	739
Receivables	2,831
Inventories	1,936
Equipment-net	<u>205</u>
	<u><u>5,711</u></u>
Liabilities	
Bank	121
Payables & Accruals	1,726
Current portion Term Loan	<u>79</u>
	1,926
Term Loan	<u>316</u>
	2,242
Shareholders' Equity	
Share Capital	199
Retained Earnings	<u>3,270</u>
	<u><u>3,469</u></u>
	<u><u>5,711</u></u>

Purchase Price Allocation Process

The Average Net Income for the five years was \$895,000, and the Purchase Price \$10,960,000, for a Price Earnings Ratio of 12.25 times equal to a Capitalization Rate of 8.17%. The difference between the Purchase Price and the Book Value of the Net Assets was \$7,491,000, which previously would have been treated as goodwill and amortized over 40 years.

In the Current Purchase Price Allocation Process:

1. All Intangible Assets are identified;
2. Their Fair Value is established;
3. Fair Values are determined for the other assets and liabilities; and
4. The purchase price is allocated on the basis of the relative Fair Values.

In identifying Intangible Assets and establishing their Fair Values, a SWOT (Strengths, Weaknesses, Opportunities and Threats) analysis is useful. At the Valuation Date, Lamb had a number of strengths:

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STRONG MANAGEMENT: The two founders, currently President and Vice President, Technology, were active in the business and would stay on for a year; their skills had been augmented by specialists in Sales & Marketing, Operations & Manufacturing, Engineering & Project Management, Customer Support and Finance.

EXPERIENCED WORKFORCE: With low employee turnover, the work-force throughout the world was loyal, many with more than ten years' service. The Engineering and Customer Support teams had the wide range of skills and knowledge required for effective product development and customer service.

ISO 9000 REGISTRATION: Management consistently strived to improve operations; by 1994, Lamb had achieved an ISO 9001 registration. In 1997, the Company successfully adopted the process management approach of the revised ISO 9000 standard proclaimed in 2000 and thereby met its requirements.

EFFICIENT MANUFACTURING: By combining subcontracting, in-house skills and supply-chain management, the gross margin for the principal manufactured product exceeded 63%.

SEVERAL MARKETS: There are many separate adoption cycles. Serving two segments in numerous countries, dairy and meat processors, with separate products, has helped smooth out market and technology peaks and troughs.

GLOBAL PERSPECTIVE: Distributors and resellers across the world, as well as five regional, authorised repair centres, ensured that customers are served in a timely manner.

CENTRALLY CONTROLLED PRODUCTS: All products, whether produced in-house or purchased from others, are compatible and have a common look.

GOOD OUT-OF-THE-BOX EXPERIENCE: Every item is designed for ease of use and simple installation; this is achieved by quick start guides, detailed and comprehensive manuals and free regional technical support.

Lamb also had one major weakness:

A single product, LAMBEST, accounts for about 60% of current revenues and purchased items represented a further 18%. This situation reflected Management's limited ability to anticipate market trends and develop appropriate products in advance of similar offerings from competitors.

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Identifying Intangible Assets

An asset is a resource controlled by an enterprise as a result of past events, from which future benefits are expected.

Financial and physical assets are combined into a number of generally accepted and well understood categories; those for intangible assets are less clearly defined. They are also more difficult to value, as their benefits may vary with the situation of their owners.

Under GAAP, intangibles are only recorded on the Balance Sheet if they are acquired in a business combination and meet certain tests; similar, internally generated items are not recorded, and their costs are expensed as incurred.

New Recognition Criteria

An intangible item is recognized as an Intangible Asset apart from Goodwill, if it meets one of two tests:

- a) Contractual/legal: It arises from contractual or other legal rights (regardless of whether or not those rights are transferable or separable from the acquired entity, or from other rights and obligations); or
- b) Separability: Either - capable of being separated or divided from the acquired entity, and sold, transferred, licensed, rented or exchanged (regardless of whether or not there is an intent to do so); or - can be sold, transferred, licensed, rented or exchanged in combination with a related contract, asset or liability.

The carrying amount of an Intangible Asset (originally Fair Value) is amortized over its useful life to the entity, unless that life is determined to be indefinite, which does not mean infinite.

To have a Fair Value, an Intangible Asset should: (a) generate some economic benefit to its owner/user, which ought to be measurable in financial terms, such as Net Income, net operating income, Net Cash Flow, etc. or (b) be able to enhance the value of other assets with which it is associated.

Intangible Assets of Lamb

During the due diligence period, Diamond established it would acquire the following Intangible Assets with Lamb:

- Sales Channels, including agreements with distributors with whom Diamond had tried to obtain a relationship;
- Brand Name "LAMBEST";
- Core Technology, mainly relating to the LAMBEST product;
- Customer Base, LAMBEST and dairy equipment users;

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- Distribution rights for products from outside suppliers;
- Engineering workforce;
- In-Process R&D, mainly related to a new LAMBMASTER product.

Approach to Fair Values

Traditionally, three approaches are commonly used to establish the Fair Values of assets and businesses: Cost, Income, and Market. The Cost Approach considers the original cost of each asset or liability, adjusting for: inflation, depreciation, time-to-market, and changes in operating conditions.

Two methods are normally applied under the Income Approach. One capitalizes Sustainable Net Income, based on past and projected profits, to give the Net Income Value; the other discounts projected Cash Flows for the Discounted Cash Flow Value.

The Market Approach relies on applying factors chosen from transactions in comparable entities, such as multiples of revenue, or price per square foot, to give a Transaction Based Value.

Financial Assets & Liabilities

Lamb's financial assets and liabilities are all either short term, or, such as the Term Loan, bear floating market rates; therefore, their Fair Values will not differ significantly from the related Book Values.

Physical Assets

Inventories are carried at the lower of FIFO cost or market, with a 10% reserve; the resulting figure is considered to be Fair Value. In view of the equipment's relatively low Book Value (\$205,000), and that much of it consisted of computer related items less than two years old, which was used to develop new and enhanced products and build prototypes, an independent appraisal was not considered necessary; Fair Value was left at its depreciated Book Value.

Intangible Assets

As recommended by the Handbook and FASB, the Fair Values of Lamb's Intangible Assets were mainly determined by the Discounted Cash Flow method.

Fair Values of the Intangible Assets

Sales Channels

Diamond originally served food processors through a direct-selling organization. As it grew outside North America by acquisitions, it started using distributors and dealers; after June 2000, all revenues came through those channels. Distribution Agreements Lamb had with firms in the UK, Holland, France, Germany, Poland, and The Peoples' Republic of China were acquired by

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Diamond and represented a major asset. In Germany, these elevated Diamond to national rather than regional coverage; in China, distributors were able to include Diamond products and supply sufficient volume to justify an in-country repair shop. In the United States, Diamond barely exceeded the minimum volume required by one significant food processing equipment distributor; together with Lamb, it easily qualified.

The sources of Lamb's revenues for Fiscal 2001 were:

Sales through Distributors	
Not used by Diamond	5,596
Shared with Diamond	<u>14,648</u>
	20,244
Maintenance Revenue	<u>1,530</u>
Total for Year	<u><u>21,774</u></u>

At a gross margin of 53.0%, sales of \$5,596,000 through distributors not used by Diamond generated a Gross Profit of \$2,966,000. Discussions with Management of Diamond, Lamb and other food equipment suppliers indicate that the value of long-term Distribution Agreements, such as those Lamb contributed, is approximately one month's Gross Profit for each year the agreement is expected to be in force. Management believes that their useful life is six years; therefore, six months' Gross Profit, or \$1,485,000, has been chosen as the Fair Value of the Sales Channels acquired.

Brand Name

LAMBEST is a leading brand of meat processing equipment in many markets, with a reputation as a solid, sturdy, easy-to-configure product. It is considered so reliable that some plants do not believe it necessary to back up their units.

During the year to August 31, 2001, LAMBEST sales were \$13,118,000, close to twice those (\$7,153,000) of the second ranked comparable product from Diamond. On a pre-tax contribution margin of 19.0%, after product enhancement costs but before corporate R&D, they would generate a net contribution of about \$646,000 a year, net of tax at 43.0%.

Even though the existing model introduced in 2000 is likely to be replaced during the next five years, the name LAMBEST is expected to be applied to the replacement. The present value, at 20% of the net contribution for ten years (two product generations), is \$1,709,000 (using a factor of 4.193 times). Rounded to \$2,700,000, this is the Fair Value of the LAMBEST Brand Name.

Core Technology

The Core Technology relates to LAMBEST; the other products use technology that was either purchased from independent suppliers or is still being developed; the major new product,

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LAMBMASTER, uses a different process and design. While the existing LAMBEST model uses certain obsolescent components, the Diamond engineering department believes that only minor modifications are needed for them to be replaced by up-to-date items.

The "relief-from-royalty" method was adopted to establish the Fair Value for the Core Technology. Licensing rates for this type of product range from 3% to 4% of sales. The middle of the range, 3.5%, applied to 2001 sales of \$13,118,000, gives about \$262,000 a year after tax. The present value at 20% of this amount over the expected five years' remaining economic life is \$783,000 (a factor of 2.990 times). Rounded to \$785,000, this forms the Fair Value of the Core Technology.

Customer Base

As Lamb sells through distributors and the warranty requirements of LAMBEST and its dairy industry equipment are slight, it has not been able to persuade all its end users to register; for that reason, there is no complete customer database. From serial numbers, shipping records and distributors' reports, a total of 2,345 installations was identified. Using a modest \$250 each (less than the cost of a sales lead) gives \$586,000; rounded, this results in a Fair Value for the Customer Base of \$585,000.

Distribution Rights

Lamb distributes three sets of products manufactured by others, with revenues for the 2001 fiscal year of \$3,176,000 at a gross margin of approximately 30%. Management believes that such Distribution Rights are worth 4% of annual revenue, and that they have a life of five years; using a 20% discount rate gives a present value of \$380,000 as the Fair Value for the Distribution Rights.

Engineering Workforce

The engineering organization, which undertakes the essential R&D as well as handling final assembly and testing for Lamb, consisted of fifteen people under the direction of the Vice President, Technology, and three Project Managers. The approach adopted to establishing its Fair Value is to estimate its Reproduction Cost by two items: head hunter charges and salaries for the time spent on the learning curve.

For the various staffing groups, the table below sets out annual payroll cost, head hunter charges and learning curve salaries. Head hunter charges are between 10% and 20% of payroll; for the Vice President, this was increased to 25%. Learning curve costs were calculated using a sum-of-the-digits approach, based on estimates of the time needed to obtain reasonable proficiency with Lamb's Core Technologies and development projects; this was nine months for the Vice President, six months for the Project Managers, and between three and five months for the engineers.

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Positions		Payroll	Head Hunter Charges	\$'000 Learning Curve Salaries
Vice President		148.7	37.2	66.0
Project Managers	(3)	316.7	63.3	87.8
Senior Engineers	(4)	253.9	38.1	47.5
Junior Engineers	(4)	201.9	30.3	33.8
Trainee Engineers	(3)	99.1	9.9	11.0
		<u>1,020.3</u>	<u>178.8</u>	<u>246.1</u>

The total cost of head hunter charges and learning curve salaries is \$424,900; rounded to \$425,000, this forms the Fair Value of the Engineering Workforce.

In-Process Research & Development

Six of the eleven R&D projects underway at the Valuation Date related to a new product, LAMBMASTER, which, at the Acquisition Date, was in the late Beta stage. A further four covered improvements to LAMBEST, and the final one was testing the potential of a purchased item. There was sufficient doubt about the technical and commercial situation of LAMBMASTER for all the related projects to qualify as In-Process R&D ("IPR&D").

Approaches Adopted

Any valuation of IPR&D must consider all relevant factors, such as: costs already incurred; stage of completion of the projects at the time of acquisition; complexity of the work to date; difficulties of achieving a commercial product within a reasonable period; technological feasibilities and uncertainties; expected amounts to complete the projects; alternative future uses; and savings in "time-to-market".

In most industries, experienced engineers can reproduce almost any product, given sufficient time and resources; however, the first supplier of a new item usually obtains a significant market position. Therefore, a reduction in time-to-market is an important feature in deciding to "build-or-buy" R&D. In determining the Fair Value of IPR&D, it is essential that such time-to-market savings be reflected.

For the Cost Approach, this is commonly expressed as a multiple of the total amounts incurred to date; the multiple will increase with: the stage of the development process; the complexity of the work to date; and the difficulty of achieving a commercial product within a reasonable time. Multiples of up to ten times incurred costs have been paid by major organizations to obtain a quickly marketable product rather than facing the delays of up to eighteen months required to develop the item in-house.

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In valuing the IPR&D of Lamb, all those factors were taken into account in the Income Approach, using the Cost Approach for support. Due to Lamb's substantial knowledge base, its costs are considered to be lower than the reproduction costs of the IPR&D by an outside party, such as Diamond. The Market Approach was not adopted, as no information was available on comparable transactions.

Future Sales

To establish the value of IPR&D by the Income Approach requires the preparation of projections of sales and related costs. Lamb had prepared the sales budgets for fiscal 2002 and forecasts for 2003 and 2004, as set out below:

Year to August 31	2001 (Actual)	%	2002 (budget)	%	2003 (forecast)	%	2004 (forecast)	%
Dairy								
Consumables	3,050	14.0%	3,300	14.3%	5,000	18.3%	7,000	22.3%
Equipment	1,924	8.8%	2,100	9.1%	2,600	9.5%	2,900	9.2%
	<u>4,974</u>	22.8%	<u>5,400</u>	23.5%	<u>7,600</u>	27.9%	<u>9,900</u>	31.5%
Change	10.5%		8.6%		40.7%		30.3%	
Meat								
LAMBEST	13,375	61.4%	13,700	59.6%	14,800	54.3%	15,400	49.0%
LAMBMASTER	-	0.0%	415	1.8%	1,300	4.8%	2,400	7.6%
Other	1,950	9.0%	1,970	8.6%	2,000	7.3%	2,100	6.7%
	<u>15,325</u>	70.4%	<u>16,085</u>	69.9%	<u>18,100</u>	66.4%	<u>19,900</u>	63.4%
Change	14.0%		5.0%		12.5%		9.9%	
Maintenance	1,475	6.8%	1,515	6.6%	1,550	5.7%	1,600	5.1%
Total Revenues	<u>21,774</u>	100.0%	<u>23,000</u>	100.0%	<u>27,250</u>	100.0%	<u>31,400</u>	100.0%
Change	11.8%		5.6%		18.5%		15.2%	

With respect to the dairy products, a substantial (13%) increase in revenue from consumables is budgeted for fiscal 2002, with further gains forecast for fiscal 2003 (52%) and 2004 (40%) as the result of an upgrade program to reduce the use of third party items.

Risks

As previously stated, six of the eleven R&D projects underway related to LAMBMASTER, and a further four covered improvements to LAMBEST; all involved significant technological and business risks. At the Acquisition Date, LAMBMASTER lacked features needed for it to meet the established specifications and satisfy market needs; the product had been returned by a number of Beta customers as unsatisfactory. Problems were not just bugs, but functionality; Diamond did not have a similar product.

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Other risks for Lamb were:

- Lack of volume in some purchased products.
- Excessive time-to-market for new items.
- Different requirements in different countries.

Fair Value of LAMBMASTER IPR&D

Lamb's Vice President of Sales & Marketing expected LAMBMASTER to generate good sales after 2002, rising to a peak in fiscal 2004 and dropping off thereafter. Based on this, sales projections were prepared for fiscal 2005 and 2006. An initial gross margin of 44% was anticipated in fiscal 2002, improving later to about 50%; LAM-BEST had a gross margin of over 63%.

The following table sets out expectations for LAMBMASTER covering the five years from the Acquisition Date to August 31, 2006, including the contribution to Lamb's Cash Flow of Lamb; as it was introducing the product after several competitors, no residual value was assumed.

Year to August 31 2002	2002 budget	2003 forecast	2004 forecast	2005 projected	2006 projected
LAMBMASTER Revenue	415	1,300	2,400	1,600	1,450
Gross Margin	44%	46%	48%	49%	50%
Gross Profit	183	598	1,152	784	725
Distribution.	(33)	(104)	(192)	(128)	(116)
R&D	(79)	(87)	(95)	(103)	(111)
Cash Flow Contribution	<u>71</u>	<u>407</u>	<u>865</u>	<u>553</u>	<u>498</u>

While the R&D group believed LAMBMASTER to be substantially completed, some of the sales force, based on user feedback, doubted its success. A possible comparison would be a new drug in Phase III trials that does not show any significant improvement over existing treatments. The feasibility of a new product should be demonstrated by the market rather than in the R&D process.

At a Discount Rate of 30% (reflecting higher risks), the Cash Flow Contribution from LAMBMASTER has a present value of \$1,016,000, while the actual costs incurred to date for LAMBMASTER's R&D based on time records was \$1,322,000. The DCF Value, rounded to \$1,015,000, is the Fair Value of the IPR&D, about 23% below the incurred costs.

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Summary of Fair Values

The identified Intangible Assets have Fair Values and economic lives as set out below. The difference between the Purchase Price and Book Value was \$7,491,000, resulting in only \$116,000 of Goodwill.

	Fair Value \$'000	Economic Life Year
Sales Channels	1,485	6
Brand Name	2,700	10
Core Technology	785	5
Customer Base	585	6
Distribution Rights	380	5
Engineering Work Force	425	3
IPR&D	<u>1,015</u>	5
Total	7,375	
Net Tangible Assets	3,469	
Goodwill	<u>116</u>	
Purchase Price	<u><u>10,960</u></u>	

Financial Reporting

For reporting purposes, under US GAAP, the IPR&D is written off immediately, while the Engineering Work Force is considered part of Goodwill, which would become \$541,000. In Canada, the IPR&D would be capitalized as a deferred cost and written off over the five year estimated life of the product.

What Actually Happened

Diamond moved LAMBEST's engineering operation into one of its plants in a nearby (30 minutes by car) city and integrated the engineering workforce into its own; the result was that, within a year or so, everybody except a sole project manager left; he be-came Vice President, Operations. LAMBMASTER was not a commercial success and was discontinued within four months.