GBQ Consulting

Value of Non-Competes: What Business Owners and Advisors Need to Know

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

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 for future competition. This article will summarize the most common approach to valuing non-competition agreements for Fair Value financial reporting purposes (which may differ significantly from any negotiated or contractually stated value), as well as highlight some of the important questions to ask when developing the assumptions utilized in the analysis (or when negotiating non-competition value as part of the purchase consideration in an acquisition).

The value of a non-competition agreement is represented by the present value of the cash flows that would be lost if the covenanter were to compete, adjusted for the effective probability that the covenanter would compete, and compete successfully. The most common approach is to utilize a method of the Income Approach, termed the Lost Income Method (more commonly referred to as the “with and without” method). The Lost Income Method utilizes the same basic methodology as the Discounted Cash Flow Method (i.e., projecting distributable cash flow and discounting future cash flow to estimate present value); however, the Lost Income Method utilizes distributable cash flow assumptions that reflect the economic reality of competition by the covenanter. To estimate the cash flows that would be lost if the covenanter competed, one first estimates a “base case” equal to the present value of the cash flows of the company in the absence of any competition from the covenanter. Next, one estimates the present value of the company’s cash flows “with successful competition.” The estimated effect of competition involves making assumptions regarding the estimated loss in sales, any change in profit margins, the impact on any other items that yield distributable cash flows (i.e., net working capital and capital expenditures) as well as the duration of these changes from the base case.

Once a successful competition value is estimated, one subtracts this value from the base case value to yield the value of damages from successful competition. Finally, one multiplies the present value of the damages by the probability of successful competition, and adds the present value of the income tax savings (related to the ability to amortize the non-competition agreement for tax purposes) to estimate the Fair Value of the non-competition agreement.

The assumptions utilized primarily revolve around the answers to three questions:

- Without the non-competition agreement, would the covenanter desire to compete?
- Is the covenanter capable of competing effectively?
- Is it feasible for the covenanter to compete, considering the market and competition by the original company?

For example, the existence of contingent and/or compensation-related payments that would be paid to a covenanter if certain performance and employment related criteria are met would diminish the covenanter's desire to compete. Moreover, the ability to compete often involves asking additional questions pertaining to the covenanter's age, talent, financial wherewithal, etc. In addition, feasibility may concern the business's barriers to entry.

There are difficult nuances within the answers to each of these questions as well as additional questions that should be considered. Please contact us with any questions or if you would like additional information.

Author:
Curtis Farrow, CPA
Senior Financial Analyst