

Accounting, Analysis and Governance in Complex Deals

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Post-Merger Integration

BMME303

Accounting, Analysis and Governance in Complex Deals

Roadmap

Post-Merger Integration

1. Accounting Foundations: **Purchase Price Allocation** and **Goodwill & Intangibles**
2. **Consolidation Mechanics**: Day 1 Accounting and Beyond
3. **Market-Based Valuation Distortions**: how purchase accounting biases multiples and the diversification discount

Learning Objectives

Post-Merger Integration

Relevant Course Learning Objectives

- Understand how (financial) information creates and solves conflicts between business leaders, oversight bodies, and other stakeholders throughout transactions.
- Critically assess complex multi-type and multi-source information in transaction-related valuations and decisions.

Learning Objectives

Post-Merger Integration

Session Learning Objectives

- Understand purchase price allocation mechanics and calculations
- Apply goodwill recognition and impairment testing
- Execute consolidation procedures for post-merger entities
- Analyze real-world acquisition accounting complexities
- Connect accounting practices to market-based valuation methods
- Explore the impact of accounting on M&A multiples and diversification discount

Today's Case Study: e.l.f. Beauty Acquires rhode

Setting the Stage

e.l.f. Beauty

e.l.f.
eyes lips face

Some Facts

- Established (2004) cosmetics brand known for its affordable products
- Focus on digital marketing and social media engagement
- Strong presence in the U.S. and expanding internationally
- "Democratize beauty" mission

Setting the Stage

Today’s Case Study: e.l.f. Beauty Acquires rhode

rhode skin by Hailey Bieber

rhode

Some Facts

- Hailey Bieber’s beauty brand launched in 2022
- Emphasis on skincare and clean beauty
- Rapid growth and strong brand loyalty among Gen Alpha consumers
- Acquisition announced May 28, 2025, closed August 5, 2025

Why Did e.l.f. Select rhode as Target?

Connecting the Dots

Value Creating Archetypes?

Primary Archetype? Accelerate Market Access for Products

- rhode provides access to premium beauty segment
- Leverages Hailey Bieber's 50M+ social media following
- Expands e.l.f.'s reach beyond mass market positioning

Secondary Archetype? Acquire Skills or Technologies Faster

- Celebrity-endorsed brand building capabilities
- Social media marketing expertise and influence

Target Selection Criteria Applied

Why Did e.l.f. Select rhode as Target?

Market Access Indicators

- Geographic revenue concentration: ✓ (US-focused, room for international expansion)
- Limited distribution infrastructure: ✓ (primarily direct-to-consumer)
- Growing products with limited reach: ✓ (skincare expansion opportunity)

Skills/Technology Acquisition

- Social media following value: ✓ (millions of Instagram followers)
- Brand influence metrics: ✓ (Celebrity association premium)
- Content creation capabilities: ✓ (Authentic beauty positioning)

Target Selection Criteria Applied

Why Did e.l.f. Select rhode as Target?

Strategic Fit

- **Multi-category platform:** e.l.f. (makeup) + rhode (skincare)
- **Channel diversification:** Mass market + Premium positioning
- **Demographic expansion:** Gen Z/Alpha/Millennial reach
- **Brand portfolio:** Value + Prestige segments

Financial Attractiveness

- Revenue scaled quickly before the deal and contributed $293.5M to e.l.f.’s FY2026 sales after closing
- Strong brand equity and customer loyalty
- Synergy potential through shared distribution

e.l.f. Beauty Acquires rhode

Result?

> **Announced as USD 800M base & up to USD 200M earnout, recorded at close at USD 896.5M (preliminary) consideration**

- 8K Filing on Acquisition
  - **USD 600M cash**
  - USD 200M stock
- 10-Q Filing with Preliminary PPA

Accounting Mechanics

From Deal Price to Balance Sheet

Purchase Price Allocation

Accounting Mechanics

What happens on Day 1?

- Closing Date = Acquisition Date = Day 1 for accounting purposes
- e.l.f. must **allocate purchase price** to acquired assets and liabilities
- **Fair value ≠ Book value** ⇒ significant adjustments required
- **Goodwill** emerges as residual amount

How?

Purchase Price Allocation Framework

US GAAP

ASC 805 Business Combinations

- […]
- **Determine the consideration transferred**
- **Recognize and measure identifiable tangible and intangible assets acquired and liabilities assumed** at fair value
- **Recognize and measure goodwill** as residual
- […]

Flood (2021) (Chapter 47) available at EUR

Purchase Price Allocation Framework

US GAAP

Consideration Transferred

Purchase Price Components

- Cash paid
- Fair value of equity issued
- Fair value of contingent consideration
- (Fair value of pre-existing relationships)

Fair Value Hierarchy

- **Level 1:** Quoted market prices
- **Level 2:** Observable inputs
- **Level 3:** Unobservable inputs

rhode Beauty Acquisition

Deal Structure at Close (August 5, 2025)

Consideration Transferred

- Acquisition announced at USD 800M base + earnout of up to USD 200M
- **Cash consideration paid** at close USD 589.1M
- **Equity consideration at acquisition-date fair value:** USD 300.3M
- **Contingent consideration fair value recognized:** USD 7.1M
- **Total preliminary consideration transferred: USD 896.5M**

> ⓘ The stock component increased between signing and closing because ASC 805 requires equity consideration to be measured at its fair value on the acquisition date, which reflects the market price at closing rather than at signing. (The e.l.f. outcome is consistent with a Fixed Share Exchange Ratio + Rising ASP)

rhode Beauty Acquisition

Deal Structure at Close (August 5, 2025)

Consideration Transferred

Item	Amount
Cash consideration	USD 589.1M
Equity consideration (common stock issued)	USD 300.3M
Valuation of potential earnout	USD 7.1M
Total consideration	**USD 896.5M**

rhode Beauty Acquisition: Purchase Price Allocation

10-Q Filing with Preliminary PPA (November 11, 2025)

Assets Acquired and Liabilities Assumed

Assets Acquired	**Amount**
Cash acquired	USD 8.5M
Accounts receivable	USD 30.0M
Inventory	USD 39.7M
Prepaids and other current assets	USD 2.2M
Property and equipment	USD 1.8M
Identifiable intangible assets	**USD 380.9M**
Identifiable Assets	**USD 463.1M**

rhode Beauty Acquisition: Purchase Price Allocation

10-Q Filing with Preliminary PPA (November 11, 2025)

Assets Acquired and Liabilities Assumed

Liabilities assumed	Amount
Accounts payable	USD (17.9M)
Accrued expenses and other liabilities	USD (59.9M)
Other obligations	USD (0.1M)
Total liabilities assumed	**USD (77.9M)**

The 10-Q notes that liabilities include $47.1M of seller expenses paid by e.l.f. at closing.

rhode Beauty Acquisition: Purchase Price Allocation

10-Q Filing with Preliminary PPA (November 11, 2025)

Net Identifiable Assets

```
Identifiable Assets = $8.5M + $30.0M + $39.7M + $2.2M + $1.8M + $380.9M
          = $463.1M

Liabilities Assumed = $17.9M + $59.9M + $0.1M
          = $77.9M

Net Identifiable Assets = Identifiable Assets – Liabilities Assumed
```

⇒ Net Identifiable Assets = USD 463.1M - USD 77.9M = USD 385.2M

rhode Beauty Acquisition: Purchase Price Allocation

10-Q Filing with Preliminary PPA (November 11, 2025)

Calculate Goodwill

Item	Amount
Total Consideration	**USD 896.5M**
Less: Net Identifiable Assets	USD (385.2M)
Goodwill	**USD 511.2M**

> *"The **goodwill represents the excess value over both tangible and intangible assets acquired and liabilities assumed**. The goodwill recognized in the transaction is primarily attributable to the Company's expectation that rhode can continue to expand distribution and deliver new skin care products."*

rhode Beauty Acquisition: Purchase Price Allocation

10-Q Filing with Preliminary PPA (November 11, 2025)

Simplified Day 1 Journal Entry

Dr. Cash acquired	$8.5M	
Dr. Accounts receivable	$30.0M	
Dr. Inventory	$39.7M	
Dr. Prepaids and other current assets	$2.2M	
Dr. Property and equipment	$1.8M	
Dr. Identifiable intangible assets	$380.9M	
Dr. Goodwill	$511.2M	
Cr. Accounts payable		$17.9M
Cr. Accrued expenses and other liabilities		$59.9M
Cr. Other obligations		$0.1M
Cr. Cash		$589.1M
Cr. Common stock		$300.3M
Cr. Contingent consideration liability		$7.1M

Complex Allocation Considerations

rhode Beauty Acquisition: Earnout Clause

Contingent Consideration Valuation

- **Contingent earnout up to USD 200M**
- **Recorded Day 1 fair value of earnout: USD 7.1M**
- Quarterly updated: probability assessments of achieving targets, discount rates
- Adjustments flow through earnings, not goodwill
- FY2026 audit report identifies this estimate as a critical audit matter

Complex Allocation Considerations

rhode Beauty Acquisition: Identifiable Intangible Assets

Technology-Based

- E-commerce platform and technology
- Mobile app and digital infrastructure
- Customer data and analytics platforms

Customer-Based

- Customer lists and purchasing history
- Social media following
- Influencer relationships and partnerships
- Brand loyalty and customer lifetime value

Complex Allocation Considerations

rhode Beauty Acquisition: Identifiable Intangible Assets

Marketing-Based

- Brand name “rhode” (trademark)
- Product formulations and trade secrets
- Endorsement and licensing agreements

Contract-Based

- Supplier and manufacturing agreements
- Distribution and retail partnerships
- Influencer collaboration contracts
- Licensing agreements for Hailey Bieber likeness

Complex Allocation Considerations

rhode Beauty Acquisition: Identifiable Intangible Assets

Beauty Industry Specifics

- FDA product registrations
- International trademark portfolios
- Retail placement agreements (Sephora, etc.)

rhode Identifiable Intangibles

⇒ **Key Principle:** Must meet both **identifiability** and **control** criteria (Deloitte)

Key Takeaways: Purchase Price Allocation

What Happens on Day 1?

Core Principles

- **Fair value measurement** drives all acquisition accounting
- **Goodwill is always the residual:** what's left after allocating to identifiable assets
- **Intangible asset recognition** requires both identifiability and control
- **Deferred tax impacts** arise from book/tax basis differences

Practical Implications

- **$511.2M goodwill** is the residual
- **$380.9M identifiable intangibles** reflect rhode's brand and customer value

Strategic Considerations

- **Purchase accounting directly impacts** future financial performance
- **Market multiples affected** by acquisition-related balance sheet changes
- **Integration planning** must consider accounting implications

Risk Factors

- **Contingent consideration** creates ongoing volatility in earnings
- **Large goodwill & intangible assets** subject to impairment risk

Goodwill & Intangible Assets

What Happens **After** Day 1?

Goodwill: The Residual Asset

Economic vs. Accounting Perspectives

Economic Goodwill Components

- Operating improvements
- Assembled workforce value
- Market power and positioning
- Management expertise
- Going concern premium

Accounting Reality

- **Goodwill is a residual**
- Includes overpayment and measurement errors
- Subject to impairment, not amortization
- Cannot be sold separately

Goodwill = Economic goodwill + Overpayment + Measurement Error

Goodwill Impairment Testing

ASU 2017-04 Simplified Approach

Step 1: Qualitative Assessment

- Assess whether **“more likely than not”** that fair value < carrying amount
- Consider: macro factors, industry factors, cost factors, entity factors

Step 2: Quantitative Testing

- Single test: Compare **reporting unit fair value** to carrying amount
- **Impairment = Max(0, Carrying Amount - Fair Value)**

ⓘ You test the reporting unit as a whole, and only then write down goodwill if there’s a shortfall.

Goodwill Impairment Testing

ASU 2017-04 Simplified Approach

Reporting Unit Definition

- Operating segment or component
- Discrete financial information available
- Management regularly reviews performance

Fair Value Methods

- Market approach (trading multiples)
- **Income approach** (DCF)
- Cost approach (rare)

Impairment Testing Example

e.l.f. Beauty Acquires rhode

rhode Reporting Unit

- Carrying amount: $896.5M
- Includes $511.2M goodwill and $380.9M identifiable intangible assets
- **Assume** qualitative assessment indicates need for quantitative testing

DCF Valuation (Assumption)

Year	Cash Flow	PV Factor (10%)	Present Value
2026	$45M	0.909	$40.9M
2027	$55M	0.826	$45.4M
2028	$65M	0.751	$48.8M
2029	$72M	0.683	$49.2M
2030	$78M	0.621	$48.4M
Terminal	$1,144M	0.621	$710.4M
			$943.1M

Impairment Testing Example

e.l.f. Beauty Acquires rhode

Impairment Analysis:

```
Reporting Unit Fair Value:      $943.1M
Reporting Unit Carrying Amount: $896.5M
Impairment Loss:                $0M (No impairment)
```

If Fair Value was $820M:

```
Carrying Amount:              $896.5M
Fair Value:                   $820.0M
Impairment Loss:               $76.5M

Journal Entry for Impairment:
Dr. Goodwill Impairment Loss    $76.5M
  Cr. Goodwill                        $76.5M
```

Goodwill

What Happens After Day 1?

Impairment Testing Realities

- **Annual testing** to be considered
- **Triggering events** can force testing (like beauty market changes)
- **Fair value determination** highly subjective and involves significant judgment
- **SEC scrutiny increasing** on documentation and methodology

e.l.f./rhode Specific Risks

- **Celebrity brand risk:** Hailey Bieber association may change
- **Social media algorithm changes** affecting influencer reach
- **Beauty market competition** and changing consumer preferences
- **Large preliminary intangible balances** represent significant impairment exposure

Strategic Implications

- **Large intangible assets** increase earnings volatility risk
- **Market multiples distorted** by acquisition accounting effects
- **Performance measurement** complicated by fair value adjustments
- **Integration success** critical to avoiding impairments

Best Practices

- **Robust documentation** of all valuation assumptions
- **Regular triggering event assessments** beyond annual requirements
- **Conservative cash flow projections** in volatile industries
- **Board oversight** of material impairment decisions

SEC Enforcement Trends

2024 Focus Areas

Recent SEC Actions

- **UPS (2024):** Failed to properly document goodwill impairment analysis
- **Sequential Brands:** Delayed impairment recognition

Enforcement Themes

1. **Triggering Event Timing:** When should testing occur?
2. **Valuation Methodology:** Consistency and reasonableness
3. **Projection Support:** Documentation of assumptions
4. **Macroeconomic Factors:** crises, inflation, interest rate impacts

Consolidation Mechanics

Creating the Combined Entity

Day 1 Consolidation

Initial Combination

Basic Consolidation Equation:

Acquirer + Acquiree (at Fair Value) = Combined Entity

Key Procedures

- **Record fair value adjustments** to acquiree's assets/liabilities
- **Recognize goodwill** as residual
- Eliminate investment account against acquiree's equity
- Eliminate intercompany transactions (rarely applicable in "clean" acquisitions)

Day 1 Consolidation

e.l.f. Beauty Acquires rhode

e.l.f. Stand-Alone Balance Sheet

Assets	Amount	Liabilities & Equity	Amount
Cash	$800M	Accounts Payable	$100M
Receivables	$300M	Debt	$200M
Inventory	$200M	Common Stock	$600M
PP&E	$500M	Retained Earnings	$900M
Total	**$1,800M**	**Total**	**$1,800M**

This is a simplified example for illustrative purposes.

rhode at Fair Value (PPA)

Assets at Fair Value	Amount	Liabilities at Fair Value	Amount
Cash + receivables + inventory + prepaids	$80.4M	Accounts payable	$17.9M
PP&E	$1.8M	Accrued expenses and other liabilities	$59.9M
Identifiable intangible assets	$380.9M	Other obligations	$0.1M
Total Assets	**$463.1M**	**Total Liabilities**	**$77.9M**
		Net Assets at Fair Value	**$385.2M**

⇒ ***Add Right to Left and That's It?***

Deferred Tax Liability

Consolidation Tax Consequences

Fundamental Tax Issues in Business Combinations

- **Financial Reporting (GAAP):** Step up assets to fair value
- **Tax Reporting:** Assets can retain historical tax basis
- Result: Book basis ≠ Tax basis

⇒ **Temporary differences between GAAP and Tax Accounting**

Deferred Tax Liability Explained

e.l.f. Beauty Acquires rhode

Assumption-Based (!) Book vs. Tax Basis Analysis

Asset Category	Book Basis (Fair Value)	Tax Basis (Historical)	Temporary[1] Difference
PP&E	$1.8M	$1.0M	$0.8M
Trade name / brand	$220.0M	$0M	$220.0M
Customer-related assets	$120.0M	$0M	$120.0M
Other intangibles	$40.9M	$0M	$40.9M
Total Difference			**$381.7M**

- Temporary differences subsequently reverse as book depreciation/amortization/impairment occurs
- Higher book- than tax-deductions
- **Higher taxable income** relative to book income

Deferred Tax Liability Explained

e.l.f. Beauty Acquires rhode

Assumption-Based (!) Book vs. Tax Basis Analysis

Deferred Tax Calculation

```
Temporary Differences: USD 381.7M
Effective Tax Rate: ~22%
Illustrative DTL: USD 381.7M × 22% = $84.0M

Journal Entry for DTL (the "Residual" Goodwill changes):
Dr. Goodwill                          $84M
  Cr. DTL                               $84M
```

⇒ e.l.f. would pay taxes on the higher taxable income while reporting lower book income to shareholders. DTL captures this future tax obligation. (PWC)

Combined Balance Sheet

e.l.f. Beauty Acquires rhode

Illustrative e.l.f. Consolidated Balance Sheet

Assets	**Amount**	**Liabilities & Equity**	**Amount**
Cash	$800 − 589.1 + 8.5 = $219.4M	Accounts Payable	$100 + 17.9 = $117.9M
Receivables & Other Cur. Assets	$300 + 30 + 2.2 = $332.2M	Accrued Expenses + Other	$59.9 + 0.1 = $60M
Inventory	$200 + 39.7 = $239.7M	Debt + Earnout	$200 + 7.1 = 207.1M
PP&E	$500 + 1.8 = $501.8M	**Deferred Tax Liability**	**$84.0M**
Identifiable Intangibles	$380.9M	Total Liabilities	469M
Goodwill (adjusted for DTL)	**$511.2 + 84 = $595.2M**	Equity	$1,800.3M
Total Assets	**$2,269.3M**	**Total L&E**	**$2,269.3M**

Where is the DTL?

e.l.f. Beauty Acquires rhode

Our Expectation

- Expected DTL = 84
- **Goodwill = 595**

Observed (e.l.f.)

- Assume DTL ≈ 0
- **Goodwill = 511**

Where did the USD 84M go?

Where is the DTL?

e.l.f. Beauty Acquires rhode

If the tax basis was stepped up, then the tax basis of the acquired assets would be equal to their fair value, eliminating the temporary difference and thus the need for a deferred tax liability.

⇒ **The hypothetical “missing” USD 84M never existed**

Integration Costs/Acquisition Related Costs

Consolidation Mechanics Cont'd

Capitalize (Rare)

- Debt issuance costs
- Equity issuance costs
- Systems integration (if creates/enhances asset)

Expense Immediately

- General integration planning
- Employee training costs
- Facility consolidation costs
- Duplicate overhead elimination

⇒ Acquisition-related costs are specifically excluded from the purchase price (consideration transferred) and do not become part of goodwill (Deloitte)

Ongoing Consolidation Considerations

Post-Day 1 Accounting

Depreciation/Amortization of Fair Value Adjustments

Illustrative (!) life allocation

- PP&E step-up: $1.8M over 10-year life = **$0.2M annual depreciation**
- Trade name / brand: $220.0M (assume indefinite life, test for impairment annually)
- Customer relationships: $120.0M over 15-year life = **$8.0M annual amortization**
- Other intangibles: $40.9M over 5-year life = **$8.2M annual amortization**

About $16.4M additional expense vs. stand-alone

Ongoing Consolidation Considerations

Post-Day 1 Accounting

Contingent Consideration Adjustments

- Quarterly revaluation based on probability/discount rate changes
- Adjustments recorded in current period earnings
- If probability increases, liability increases

Key Takeaways: Consolidation Mechanics

Building the Combined Entity

Consolidation Essentials

- **Basic Consolidation Equation**:
  Acquirer + Acquiree (at Fair Value) = Combined Entity
- **Fair value adjustments** fundamentally change balance sheet structure: **$380.9M in identifiable intangibles** and **$511.2M goodwill**
- **Deferred tax** issues arise from temporary book-tax differences and impact goodwill

Integration Cost Management

- **Most integration costs expensed** immediately, not capitalized
- **$7.2M of acquisition transaction costs** were disclosed in the first post-close 10-Q; broader integration costs were not separately broken out
- **Systems integration** may qualify for partial capitalization

Ongoing Financial Impact

- **Illustrative $16.4M additional annual depreciation/amortization** from fair value step-ups
- **Contingent consideration volatility** affects quarterly earnings
- **Brand impairment risk** remains material given the large preliminary intangible asset balance

Strategic Considerations

- Business combinations increase **financial reporting complexity**
- **Performance measurement** should adjust for purchase accounting effects
- **Integration success** critical to justifying “eye-popping sum”
- **Market multiple comparisons** complicated by acquisition accounting ?

Equity Market Impact

From Accounting Mechanics to Valuation Consequences

Key Figures from e.l.f.’s Consolidated Balance Sheet:

- **$511M goodwill** added to assets
- **$381M identifiable intangible assets** recognized
- **An additional $7M contingent consideration liability** recorded at Day 1 fair value

Affects Market-Based Valuation?

Critical Question: Market Impact

From Accounting Mechanics to Valuation Consequences

Market Multiples Recap

- **P/E ratios** for comparable companies
- **M/B ratios** for asset-based valuation
- **EV/EBITDA** multiple considers debt
- **Assumption:** Comparable accounting across firms

Concerns?

- **Future P/E ratios** impacted by intangible amortization
- **e.l.f.'s M/B ratio** will be affected by $511M goodwill
- **Peer comparisons** may be distorted by acquisition activity

⇒ ***Are we measuring performance or accounting artifacts?***

How Accounting Distorts Market-Based Valuations

Connecting Accounting Foundations to Market Multiples

The Diversification Discount Puzzle

Connecting Accounting to Corporate Finance

Theory

- Decisions *within a hierarchy* are determined by *power considerations*: internal capital markets might misallocate resources (Coase, 1937)
- Conglomerates incur **inefficient resource allocation** compared to focused firms (Rajan, Servaes, and Zingales 2000)

Traditional Research Finding

- **Conglomerates trade at 10-15% discount** to focused firms (Stein 2003)
- **Persistent across time periods** and methodologies
- Measured using **excess value**: Firm's q vs. industry-matched portfolio q

The Diversification Discount Puzzle

Connecting Accounting to Corporate Finance

Why do conglomerates consistently trade at a discount?

- Indeed **agency costs** (theory) or actually **measurement issues**?
- Remember: market-based valuation (multiples) assumes comparability across firms
- **Accounting differences** can break this assumption (purchase accounting adjustments)
- Conglomerates are more acquisitive!

The Accounting Bias Mechanism

How Purchase Accounting Distorts Multiples

Standard q Calculation

$$q = \frac{\text{Market Value of Assets}}{\text{Book Value of Assets}}$$

The Problem with Market-to-Book (q) Ratios

1. **Conglomerates are more acquisitive** than focused firms
2. **Each acquisition** increases book value
3. **Fair value step-ups** and goodwill additions inflate denominator
4. **Market value** may not increase proportionally
5. **Result: Systematically lower q** for serial acquirers

The Accounting Bias Mechanism

How Purchase Accounting Distorts Multiples

e.l.f./rhode Example Impact

- **Book value increases** due to purchase accounting (driven by $892M from recognized IP and goodwill)
- Market may not immediately reflect full value of acquisition

⇒ **Mechanical decrease in q** from accounting, **not economics**

Evidence? Custodio (2014)

Mergers and Acquisitions Accounting and the Diversification Discount

Empirical Evidence: Custodio (2014)

Mergers and Acquisitions Accounting and the Diversification Discount

Research Design

- **Sample:** 59,106 firm-year observations (1988-2007)
- **Method:** Compare standard vs. goodwill-adjusted excess value measures
- **Key Innovation:** Subtract goodwill from book value of assets

Empirical Evidence: Custodio (2014)

Mergers and Acquisitions Accounting and the Diversification Discount

Standard Diversification Discount

- **Without firm fixed effects:** 9-10% discount
- **With firm fixed effects:** 2-3% discount

Supporting Evidence

- **Conglomerates more acquisitive:** 1.43 vs. 1.19 deals per year
- **Higher goodwill ratios:** 9.45% vs. 5.6% of assets
- **Purchase accounting effects:** 70% of deals show negative excess value

Goodwill-Adjusted Results

- **30% reduction** in estimated discount (9% → 6%)
- **With fixed effects:** 76% reduction (3% → 0.5-1.7%)
- **Discount no longer statistically significant**

Alternative Measures

- **Market-to-sales ratios:** Still show 18-21% discount
- **No accounting bias** in sales-based measures
- **Suggests real effects** beyond pure accounting

Implications for Market-Based Valuation

How Purchase Accounting Distorts Multiples

Accounting-Affected Multiples

- **P/E ratios:** Affected by amortization of fair value step-ups
- **M/B ratios:** Directly impacted by goodwill and fair value adjustments
- **EV/EBITDA:** denominator affected if EBITDA includes integration costs
- **Asset-based measures:** All subject to purchase accounting distortions

Impact on Comparable Company Analysis

- **Serial acquirers** systematically undervalued vs. organic growers
- **Recent acquirers** vs. non-recent acquirers comparison issues
- **Industry comparisons** biased if M&A activity varies

Revenue-Based Multiples (Less Biased)

- **Price/Sales:** Generally not affected by purchase accounting
- **EV/Revenue:** Similarly unbiased by balance sheet adjustments
- **Revenue multiples** may provide cleaner comparisons

Practical Implications

- **Adjust for goodwill** when using book-value-based multiples
- **Consider acquisition history** of comparable companies
- **Use revenue-based multiples** as cross-check
- **Account for purchase accounting** in peer selection

Accounting Bias in Practice

e.l.f. Beauty Acquires rhode

Goodwill-Adjusted Analysis

Adjustments for e.l.f.

- **Remove $511M goodwill** from book value
- **Recalculate adjusted M/B ratio**

```
Original Book Assets: $2,269M
Less: Goodwill: $511M
Adjusted Book Assets: $1,758M

Revised M/B Ratio:
Market Value / Adjusted Book Value
= Higher ratio, more comparable to peers
```

- **Consider impact on other ratios**

Peer Comparison Considerations

- **Check acquisition history** of comparable companies
- **Adjust peer ratios** for their goodwill levels
- **Consider time since major acquisitions**
- **Use revenue multiples** as verification

Market-Based Valuation Distortions

Key Takeaways on How Purchase Accounting Distorts Multiples

The Core Problem

- **Purchase accounting artificially inflates** book values of acquisitive firms
- **Market multiples become biased** against serial acquirers
- **Diversification discount may be overstated** due to accounting effects
- **Revenue-based multiples** provide cleaner comparisons than asset-based metrics

Practical Solutions

- **Adjust goodwill** when comparing book-value-based multiples
- **Consider acquisition history** of all peer companies
- **Use multiple valuation approaches** including revenue multiples
- **Document adjustment methodologies** in fairness opinions

Market-Based Valuation Distortions

Key Takeaways on How Purchase Accounting Distorts Multiples

Strategic Implications

- **Market punishment** for acquisitive companies can be accounting-driven
- **Investor communication** critical about acquisition impacts
- **Integration success** vital to overcome accounting distortions

Research Insights

- **Academic findings suggest** much of diversification discount is measurement error
- **Implications** for how we measure corporate performance
- **Methodological improvements** needed in comparative analysis

Thank You!

RSM Ezafus

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