Steve Leimberg's Business Entities Email Newsletter - Archive Message #245
Date: 05-Jan-22
From: Steve Leimberg's Business Entities Newsletter
Subject: Evan Levine & Nainesh Shah: Consumer Based Corporate Valuation

“ The true purpose of business is to create and keep customers.” – Peter Drucker

Evan Levine and **Nainesh Shah** provide members with commentary that examines what they refer to as “ consumer based” corporate valuation.

Evan Levine is a Chartered Financial Consultant with over 30 years of experience. He has given dozens of educational seminars on retirement and estate planning. His articles have appeared in the CPA Journal, The National Public Accountant, and Advisor Today.

Nainesh Shah is a Chartered Financial Analyst with over 25 years of experience. He is a member of the CFA Institute and has presented to over 100 audiences of financial advisors and non-profits on macroeconomic conditions, capital markets, portfolio construction and risk management.

Here is their commentary:

EXECUTIVE SUMMARY:

Accounting for customers and the value that they create is an untapped resource for investors and business managers. Understanding the value of your customers is an important financial metric not to be overlooked, especially considering the recent growth of subscription-based businesses. Customer-Based Corporate Valuation (CBCV) is a valuation approach that uses customer information such as retention and acquisition rates to predict financial data, and thus an accurate valuation of a firm. CBCV is now considered a mainstream valuation currently used by private equity, venture capital, and investment firms to better identify and estimate value.

Reporting information used in CBCV is not required by the SEC, and thus is not commonplace in public financial reporting. CBCV depends on retention rates and onboarding costs to predict revenue, profit, and value. This differs from the common “ top-down” approach of public and private market valuations that uses revenue and growth figures to predict future forecasts. The CBCV is a “ bottom-up” approach used to predict future revenues and create an accurate fair market value of a company.

COMMENT:

Creating a CBCV requires financial statements, a model for consumer data, and customer data that is then fed into the model.[i] Inside the model, there are four subsections, each of which forecasts an aspect of customer behavior.

1. **Customer acquisition** model--inflow of new customers.
2. **Customer retention** model--how long customers will remain active.
3. **Purchase mode**--how frequently customers will do business with a firm.
4. **Basket size**--amount customers spend per purchase.

CBCV is best applied to the valuation of companies with predictable or subscription-based revenue streams. It is also appropriate to value companies with a base of consistent customers and similar spending patterns. Examples of the subscription-based model include Amazon, Apple and Verizon. These are highly valuable companies due to their large market share, lack of competitors, low customer acquisition cost as compared to revenue, and high customer retention rate. It can even be applied to companies like Apple, where the customer base is stable and spends consistently on applications or for hardware.

Customer Fundamentals and their Effect on Business

Generally, customer acquisition cost (CAC) is a large marketing expense that is necessary for a business to grow. Unfortunately, it is difficult to reduce CAC, but if customer retention increases, the need for new customers, and thus total CAC, is lowered. A company with a low customer retention rate and large CAC cannot survive. This was demonstrated in the IPO of the meal subscription service Blue Apron. The 2017 IPO value of Blue Apron stock of $140 per share is currently worth $4 per share. This poor performance is due to its disappointing customer outlook. To this point, Blue Apron lost 70% of its customers after 6 months, marketing costs were 18% of revenue, customer acquisition costs increased, and customers were spending less and less on the meal service.

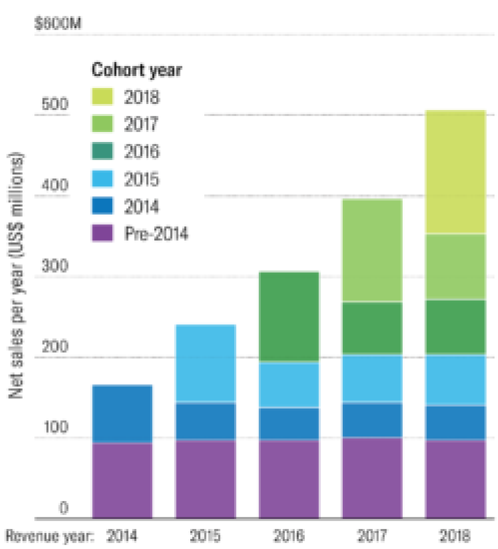
Theta Equity Partners compared Blue Apron to Stitch Fix[ii] an online personal styling service based on a user's budget. Stitch Fix has performed well as the value of its stock issued following its 2017 IPO increased from

$15 per share to its current value of $44 per share. The difference between the performance of the two companies is customer fundamentals. As stated previously, Blue Apron lost significant value due to its large CAC, decreased spending per customer, and low customer retention rate. Conversely, the profitability of Stitch Fix is based on its low marketing cost compared to revenue (7% compared to Blue Apron's 18%) and an estimated CAC of $35-$40. Stitch Fix also has a strong retention rate due to 86% of revenue generated by repeat customers as well as increased spending per customer.

Customer Cohort Chart

A Customer Cohort Chart (C3) is a new tool for corporate valuations that have been included in several new techs and subscription-based companies' public filings. Although it is not a required disclosure, many investors have become interested in C3's and other metrics that illustrate customer lifetime value and growth.

The following chart from Revolve Clothing's 2019 SEC public filing demonstrates the new acquisitions and the current number of customers indicative of customer retention, loss, and growth. Revolve went public in 2019 and achieved large gains attributable to its high customer retention rates as well as its high rate of growth and customer onboarding rates.



From: "How to Value a Company by Analyzing Its Customers," by Daniel McCarthy and Peter Fader, January–February 2020 HBR

Also, companies have begun to show their customer lifetime values (CLV) in their public filings with the SEC. Since customer valuation metrics are not required by the SEC, they remain unregulated and unaudited. Notably, Peloton claimed that their CLV was $3,593, but did not discount its CLV. Applying a discount would have reduced its value by over 50%. This is why it is important to verify information that may be misleading. The chart below of the discounted cash flow exemplifies why applying a reasonable discount rate on expected future cash flows provides a better projection of fair value. Although the cash flows from customers per period can be very high, customer lifetime value should be discounted properly to avoid the overvaluing of cash flow. This table shows a simple comparison of the effect of the discount rate on the CLV for a customer.

Year	Cash Flow From Customer	Growth Rate	Discount Rate of 0%	Discounted Cash Flow
2021	100,000		0%	100,000
2022	110,000	10%	0%	110,000
2023	121,000	10%	0%	121,000
2024	133,100	10%	0%	133,100
2025	146,410	10%	0%	146,410
			Net Present Value	$610,510

Year	Cash Flow From Customer	Growth Rate	Discount Rate of 15%	Discounted Cash Flow
2021	100,000		0.869565	86,956.52
2022	110,000	10%	0.756143	83,175.80
2023	121,000	10%	0.657516	79,559.46
2024	133,100	10%	0.571753	76,100.36
2025	146,410	10%	0.497177	72,791.65
			Net Present Value	$398,584

CBCV is a unique valuation method. So, to ensure optimal valuation results, the following are basic do’ s and don’ ts:

1. Do exercise due diligence with respect to customer-related information to ensure its accuracy;

2. Do rely on financial statements and customer data models in creating the valuation;

3. Don’ t rely on unverified information; and,

4. Don't employ an asset-based or market-based approach for the valuation of subscription-based firms.

Conclusion:

CBCV is a relatively new valuation method for businesses with predictable or subscription-based revenue streams. In contrast to a "top-down" approach of public and private market valuations that rely on revenue and growth data, CBCV is a "bottom-up" valuation approach that relies on customer information such as retention and acquisition rates. In the valuation of businesses with subscription-based revenue streams, CBCV usually results in a higher valuation than other methods.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Evan Levine

Nainesh Shah

CITE AS:

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CITATIONS:

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[i] *How to value a company by analyzing its customers*. Harvard Business Review. (2021, June 2).https://hbr.org/2020/01/how-to-value-a-company-by-analyzing-its-customers.

[ii] https://www.sec.gov/Archives/edgar/data/1746618/000156459018023704/ck0001746618-s1.htm