Transfer Pricing and the Valuation of Firms within a Multinational Group

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Applying valuation methods uniformly across different members of a multinational group may not always produce reliable results. Affiliates generally perform different functions, utilize different assets, and may assume vastly different risks when compared to the consolidated group. The valuation methods and assumptions need to reflect those differences.

Most importantly, the appraiser also needs to evaluate whether the historical and projected financial results of the different affiliates reflect arm's-length transfer pricing among members of the group, and whether adjustments to income and future cash flows need to be considered.

When valuing different legal entities, consider the following questions:

1. Are the results of related-party transactions consistent with arm's length transfer pricing principles?
2. What is the appropriate discount rate?
3. What are appropriate guideline companies?

This article briefly addresses these questions and provides some practical advice.

Arm's-Length Pricing

Any valuation depends critically on financial measures such as free cash flow or earnings before interest and tax ("EBIT"). Without assurance that the terms of intercompany transactions are consistent with arm's-length pricing, one cannot be confident that legal-entity financial results – and thus the projections of future free cash flows - are reliable.

The extent and complexity of related-party, or controlled, transactions will generally determine how important transfer pricing is to an entity's results. The financial results of an entity that has relatively few and less controversial controlled transactions will not be as dependent on transfer pricing as the financial results of an entity with extensive and complex controlled transactions. The valuation of the entity with extensive and complex intercompany transactions will depend importantly on how those controlled transactions are transfer priced.

A useful starting point for evaluating the extent and complexity of controlled transactions and whether the results are arm's length is to review the entity's transfer pricing documentation. Most tax authorities require taxpayers to maintain documentation supporting the arm's-length pricing of their controlled transactions. Carefully review the documentation to understand the extent of controlled transactions and how those transactions affect the overall results of the entity. Consider sensitivity testing to assess how the legal-entity results could change with adjustments to the transfer pricing methods. For example, how would the value of the entity change if a return related to intercompany transactions were adjusted a few percentage points up or down? How would those changes affect the results of other affiliates and the distribution of profit within the multinational group?

If such transfer-pricing documentation does not exist, consider other means of measuring the effect of transfer pricing on an entity's results. First, work to identify the material controlled transactions. Next, understand how those transactions are transfer priced and how they affect the results of the entity. Pay special attention to complex and controversial intercompany transactions like royalties and management fees to understand the nature of those transactions and to ensure that the transfer pricing is appropriately supported.

Lastly, be aware of potential controlled transactions that may not be explicitly transfer priced, but which are important to the results of the entity. For example, is the affiliate using valuable intangible property ("IP") that is owned by another affiliate without compensation? This valuable IP may be in the form of know-how or trade secrets. If this intangible transfer is not recognized and transfer priced , then the affiliate using the IP may have greater profits than appropriate and the owner affiliate would have lesser profits than it would otherwise.

Discount Rates

Even with arm's-length pricing and an appropriate distribution of profit within the group, the valuation assumptions may need to be different when valuing specific affiliates. The projected earnings of the different affiliates may have different characteristics than the group as a whole. An entity with a higher projected return might have much greater volatility in earnings than a routine entity with a lower, steadier return. When valuing such entities using a discounted cash flow method, the discount rates should reflect such differences. The weighted average cost of capital ("WACC") of the overall group might not be the best discount rate for individual entities within the group.

When identifying an appropriate discount rate, consider the functions performed and risks borne by the particular entity. Although a multinational group may be fully integrated as a whole, the functions performed by a subsidiary may be more limited. For example, the local affiliate may perform only distribution functions and have a relatively fixed operating margin. Thus *beta*, which measures the covariance of an asset with the overall market and is an important factor in determining the cost of equity, may differ considerably for this type of local affiliate when compared to the overall group.

The capital mix between debt and equity may also differ substantially between subsidiaries, which will, all other things constant, result in a different WACC. One should also consider local valuation considerations such as the risk-free rate and the equity risk premium for the particular market.

Guideline Companies

The same factors for identifying an appropriate discount rate apply to identifying guideline companies for determining multiples for valuing an entity. Companies that are comparable to the overall group might not be comparable to an individual member of the group. For example, a set of fully integrated manufacturers might not be the best set for identifying multiples for valuing a more limited distributor or service provider within the group. The valuation multiples of these different types of companies can differ considerably.

Summary

Three common valuation shortfalls when valuing affiliates within a multinational group are (1) assuming that the financial results of the different members within the group reflect arm's-length transfer pricing; (2) applying the same discounted cash flow valuation assumptions across all members of the group, and (3) using guideline companies that are comparable to the consolidated group, rather than the affiliate being valued.

Transfer pricing issues in particular can have a large effect on the projected profitability and value of different affiliates, and it is important to ensure that the results are appropriate. Additionally, subsidiaries may differ considerably in the functions they perform and risks they assume. The valuation assumptions utilized should properly reflect those differences. The appraiser should critically assess the functional and risk profile, intercompany transactions, and projected financial results of each affiliate and evaluate each affiliate separately.

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