

Intellectual Property Valuation Analysis For Sale, Transfer, Or License Purposes

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Discussion Outline

1. Defining the valuation analyst's assignment
2. Data gathering and due diligence procedures
3. Generally accepted IP valuation approaches, methods, and procedures
4. Performing the valuation synthesis and reaching the value conclusion
5. Defending the valuation analysis conclusion



Defining the Valuation Analyst's Assignment

1. Alternative analysis purposes
 - estimating a sale price between a willing buyer/willing seller
 - estimating a royalty rate between a willing licensor/willing licensee
 - estimating a value to the current owner/operator
 - estimating a value to a specific buyer owner/operator
 - estimating an intercompany transfer price (royalty rate) between related parties
 - estimating economic damages related to an IP damages event
 - concluding the fairness of a sale price or a license royalty transaction
 - concluding a mutual exchange ratio for two IP bundles



Defining the Valuation Analyst's Assignment (cont.)

2. Alternative analysis purposes

- intended objective: value (to an owner/operator), transaction price, third-party license royalty rate, lost profits/economic damages, fairness
- alternative standards of value (value to whom?)
 - fair value
 - fair market value
 - use value
 - user value
 - owner value
 - investment value
 - acquisition value
 - collateral value
- alternative premises of value (how the transaction occurs)
 - value in continued use
 - value in place (not in use)
 - value in exchange—orderly disposition
 - value in exchange—voluntary liquidation
 - value in exchange—involuntary liquidation
- highest and use analysis
 - current owner/operator HABU
 - new owner/operator HABU
 - licensor/licensee HABU



Defining the Subject Intellectual Property

1. Develop a clear and complete definition of the analysis subject
 - intellectual property: trademarks, patents, copyrights, trade secrets
 - other related intangible assets, such as:
 - trademarks—advertising materials, trade dress
 - patents—product/process drawings, proprietary technology
 - copyrights—software, masks and masters
 - trade secrets—customer lists, product formulae
 - subject bundle of IP legal rights
 - fee simple
 - term/reversion interest
 - licensor/licensee interest
 - domestic/international interest
 - product line/industry interest



Defining the Subject Intellectual Property (cont.)

1. Develop a clear and complete definition of the analysis subject (cont.)
 - licensor/licensee responsibilities
 - legal protection
 - R&D expenditures
 - marketing expenditures
 - licenses, permits, regulatory approvals
 - other contract terms
 - minimum use, production, sales
 - minimum marketing, commercialization expense
 - R&D technology development, completion payments
 - obtain required approvals
 - milestone license payments



Data Gathering and Due Diligence Procedures

1. Analysis to the current owner/operator (use/user)
 - historical and prospective financial statements
 - historical and prospective development/maintenance costs
 - current and expected resource/capacity constraints
 - description and estimate of IP economic benefits
 - revenue (unit price/volume, market size/position)
 - expense (decrease product returns, COGS, SGA, R&D)
 - investment (inventory, capx)
 - risk (contracts, cost of capital)

2. Analysis to an alternative owner/operator (use/user)
 - change in market definition or size
 - change in alternative/competitive uses
 - IP creates inbound/outbound opportunities
 - owner operate and license IP (different products, territories)



Data Gathering and Due Diligence Procedures (cont.)

3. Analyze projections and IP economic benefits against benchmark comparison

- prior projections vs. prior actual results
- current projections vs. capacity constraints
- current projections vs. market size
- consider industry average comparable profit margins (CPM)
- consider guideline public company comparable profit margins
- consider quality and quantity of guideline IP license data
- perform IP remaining useful life (RUL) analysis, based on:
 - legal/statutory life
 - contract/license life
 - technology obsolescence life
 - economic obsolescence life
 - prior generations of the subject IP
 - position of subject IP in its life cycle



Data Gathering and Due Diligence Procedures (cont.)

3. Analyze projections and IP economic benefits against benchmark comparison (cont.)

- data sources commonly used to identify industry average profit margins for IP owner/operators
 - Financial Research Associates—*Financial Studies of the Small Business*
 - The Risk Management Association—*Annual Statement Studies: Financial Ratio Benchmarks*
 - BizMiner (The Brandow Company)—*Industry Financial Profiles*
 - CCH, Inc.—*Almanac of Business and Industrial Ratios*
 - Fintel, LLC—*Fintel Industry Metrics Reports*
 - MicroBilt Corporation (formerly IntegraInfo)—*Integra Financial Benchmarking Data*
 - ValueSource—*IRS Corporate Ratios*
 - Schonfeld & Associates, Inc.—*IRS Corporate Financial Ratios*



Valuation Approaches and Methods

1. Income approach methods

- yield capitalization involves an annual uneven income projection over a finite projection period
- direct capitalization involves an annual constant change rate income projection over either a finite period or a perpetuity period
- typical IP income measures:
 - incremental income (with vs. without IP)
 - excess/residual income (business enterprise income less capital charge on all contributory assets)
 - profit split (percentage of business enterprise income assigned to IP, based on a “functional analysis”)



Valuation Approaches and Methods (cont.)

1. Income approach methods (cont.)

- typical IP income levels:
 - net operating income
 - EBIT
 - pretax income
 - contribution income (for economic damages analysis)
- discount/capitalization rate should agree with the selected income measure
- discount/capitalization rate should agree with selected standard of value and the selected premise of value
- projection period should agree with the IP RUL
- income projection should consider the shape of IP life cycle
- income projection should consider the IP maintenance costs



Valuation Approaches and Methods (cont.)

2. Market approach methods

- comparable profit margin method:
 - compare guideline public companies without IP to the subject company with IP
 - difference in profit margins is due to the subject IP
 - profit margin delta is considered to equal a royalty rate
 - royalty income (i.e., rate x revenue) is capitalized over RUL to indicate value
- note that, typically, guideline companies also have IP
- so the CPM method compares the superior subject IP profit margin to an industry average IP profit margin
- typically, EBIT is used as the CPM income measure



Valuation Approaches and Methods (cont.)

2. Market approach methods (cont.)

- data sources commonly used to identify guideline companies and guideline company profit margins:
 - FactSet Research Systems, Inc.—FactSet
 - Hoover's, Inc.—Hoover's Company Records
 - Mergent, Inc.—MergentOnline
 - Morningstar, Inc.—Morningstar Equity Research
 - Standard & Poor's—CapitalIQ
 - Thomson Reuters—Thomson ONE Analytics



Valuation Approaches and Methods (cont.)

2. Market approach methods (cont.)

- comparable uncontrolled transactions (CUT) method:
 - select guideline license agreement CUTs of comparable IP
 - adjusted CUT royalty rates for differences in guideline IP vs. subject IP
 - calculate mean/median/mode CUT license royalty rates
 - select royalty rate appropriate to the subject IP
 - royalty income (i.e., rate x revenue) is capitalized over RUL to indicate value
- consider relative age of guideline IP vs. subject IP
- consider relative market size of guideline IP vs. subject IP
- consider relative growth rate of guideline IP vs. subject IP



Valuation Approaches and Methods (cont.)

2. Market approach methods (cont.)

- data sources commonly used to identify IP CUT royalty rates:
 - AUS Corporation—RoyaltySource Royalty Rates
 - Financial Valuation Group—The Intellectual Property Transaction Database
 - ktMINE, LLC—ktMINE
 - RoyaltyStat, LLC—RoyaltyStat



Valuation Approaches and Methods (cont.)

3. Cost approach methods

- particularly applicable for recently developed IP, for which development cost or effort data are available
- also applicable for in-development or non-commercialized (e.g., defensive) IP
- replacement cost new (RCN) includes:
 - direct costs (person-months x cost per month)
 - indirect costs (out-of-pocket costs)
 - developer's profit (return on investment)
 - entrepreneurial incentive (opportunity cost during development)



Valuation Approaches and Methods (cont.)

3. Cost approach methods (cont.)

- less depreciation (LD) allowances for:
 - functional obsolescence (excess operating costs)
 - technological obsolescence (age/life before replacement)
 - economic obsolescence (inadequate ROI)
- owners often don't track IP development costs
- all conceptualization/commercialization costs should be included
- consider subject IP RUL for obsolescence
- remember, value is RCNLD, value is not RCN



Valuation Synthesis and Conclusion

1. How to select valuation approaches and methods to use
 - does selected method accomplish the analyst's assignment?
 - defined value
 - transaction price
 - third-party license rate
 - intercompany transfer price
 - economic damages
 - IP bundle exchange ratio
 - transaction fairness opinion
 - does selected method analyze the appropriate bundle of legal rights?
 - are there sufficient available data to perform the method?
 - will the method be understandable to the intended audience?



Valuation Synthesis and Conclusion (cont.)

2. How to weight the various approach/method value indications to conclude a final value
 - analyst's confidence in the quantity and quality of data
 - analyst's level of due diligence performed on data
 - relevance of the method to the subject IP life cycle stage and marketability
 - variation in the range of value indications range
 - final value can be point estimate or a value range (for transaction negotiations or fairness opinions)



Defending the Value Conclusion

1. Defending the value, price, royalty rate, economic damages, exchange ratio, fairness conclusion
 - explain the valuation (or price, royalty rate, etc.) assignment
 - describe the subject IP and the subject bundle of legal rights
 - explain the selection/rejection of all generally accepted valuation approaches and methods
 - explain the selection and application of all specific analysis procedures
 - describe the data gathering and due diligence procedures
 - list all documents and data considered
 - include copies of all documents specifically relied on



Defending the Value Conclusion (cont.)

1. Defending the value, price, royalty rate, economic damages, exchange ratio, fairness conclusion (cont.)
 - summarize all of the qualitative analyses performed
 - include schedules and exhibits of all quantitative analyses
 - avoid any unexplained or unsourced variables/assumptions
 - allow for the replicability of all analyses
 - encourage the reader's reliability of the written report
 - report should be clear, convincing, and cogent
 - report should be well-organized, well-written, and well-presented
 - report should be free of grammar, punctuation, spelling, and mathematical errors



Summary and Conclusion

1. Understand the analyst's assignment
2. Understand the subject IP and the subject legal rights
3. Collect sufficient owner/operator financial data
4. Collect sufficient industry, market, competitive data
5. Document the specific IP economic benefits
6. Perform due diligence procedures on all available data
7. Select and apply income, market, and cost approach valuation methods
8. Reconcile all value (price, royalty rate, etc.) indications into a final conclusion
9. Defend the analysis conclusion in a replicable and well-documented report

