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 owner value
 - fair market value investment value
 - use value
- acquisition value
- user 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

- 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.)

- 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.)

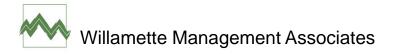
3. Analyze projections and IP economic benefits against benchmark comparison (cont.)

- 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")



- 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



- 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



- 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



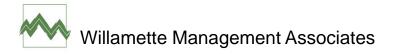
- 2. Market approach methods (cont.)
 - comparable uncontrolled transactions (CUT) method:
 - select guideline license agreement CUTs of comparable IP
 - adjusted CUT royalty rates for differences in guideline IP vs. subject IP
 - calculate mean/median/mode CUT license royalty rates
 - select royalty 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



- 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



- 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)



- 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



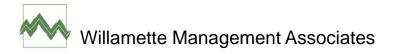
Valuation Synthesis and Conclusion

- 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 welldocumented report

