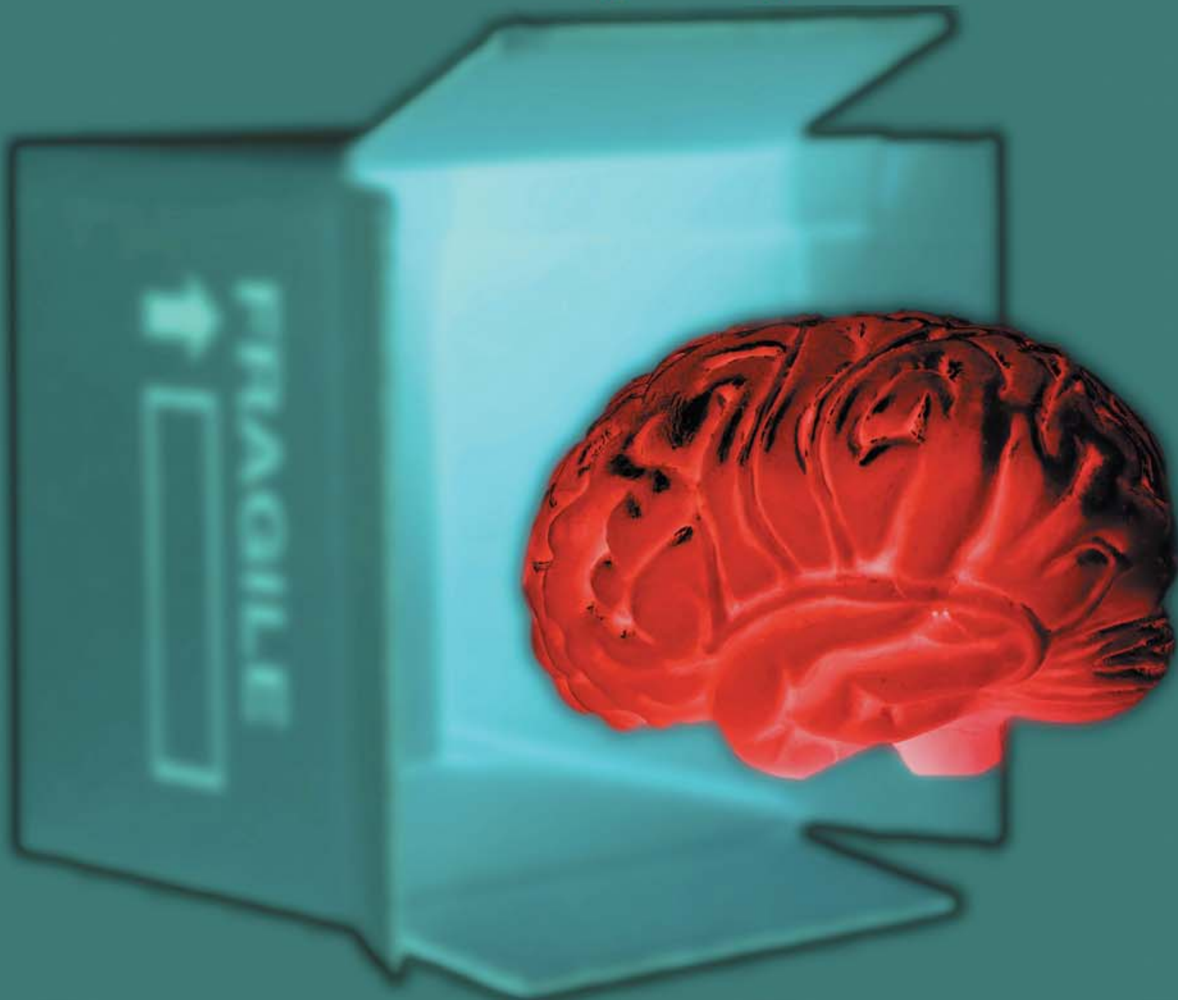
Intellectual Property Valuation



Context is Critical

by Daryl Martin and David C. Drews

In part one of this three-part series, we discussed the concept of intellectual property used as collateral for securitization and lending. We stated that intellectual capital is more readily available for strategic use than ever before. Whether the IP owner is interested in a straightforward loan using valuable trademarks and customer lists as collateral, or in securitizing the royalty payments associated with licensed assets, there

(Continued on page 24)

are options available today that will help to reduce risk, increase return and provide flexibility for resourceful owners of intellectual property.

In part two, we bring forward a discussion of the critical factors affecting the value of the intangible-asset portfolio. When considering the value of intellectual property used as collateral for lending or securitization, it is important to understand that the value of these assets will vary depending on the context of the valuation. In fact, the context is the single most important determinant of value. For example, the value of a trademark or other intangible asset is likely to be worth more to a large manufacturer in a relevant industry than to a small business entrepreneur just starting out.

Intellectual property is not a finite asset in the way that tangible assets are. When a manufacturing plant is purchased and used according to its capacity, no additional value can be extracted from the asset. Similarly, one cannot sell the same plant over and over again.

In contrast, intellectual property has no such limitations. A corporate brand can be applied to as many products and as many units of those products as the corporation can produce. In a similar fashion, a patent contains no limitation on the number of products featuring the invention or units of those products that can be produced over the patent's useful life. Consequently, large corporations can extract tremendous value from intellectual property because they can typically produce, sell and distribute substantially more products than a small entrepreneur.

Large manufacturers typically possess more of the complementary factors required to unlock the potential value of the intellectual property. These factors include assets such as a skilled work force, abundant capital, an effective marketing program and proven distribution channels, among others. The presence or absence of any one of these factors can have a significant impact on the value of the intangibles. These factors differ from one scenario to the next and the same asset will have different values when viewed in the context of a large corporation, a joint venture, or a company going through reorganization.

Asset identification

An important part of identifying the valuation context is the determination of which assets are to be included in the analysis. Patents, trademarks and copyrights are the usual focus. However, other intangibles can have a significant impact on the firm's success. Among these are slogans, characters, packaging design, non-compete clauses, proprietary sales methods, effective customer lists, trade secrets and formulae.

When considering the context of the analysis, it makes sense to view these assets in terms of their relation to one another. For example, the intangible assets utilized in the marketing process may be more accurately valued as an integrated package of assets rather than as stand-alone assets. This is because related assets tend to reinforce each other in the marketplace. With marketing assets, the overall package may consist of the brand name, logo and worldwide trademark registrations, secondary trademarks and logos, trade dress, Websites, and any other assets that contribute to the promotion of the company, the brand or the products.

This bundling approach applies to all forms of intellectual property, whether the focus is technology such as patents, trade secrets and formulae, or knowledge and skills assets such as proprietary training manuals, operating procedures or customer lists. Whatever package is deemed most appropriate for the immediate context, the bundling technique provides a solid foundation for a realistic valuation exercise. Listed below are the most common bundles of intangibles assets contained within a corporation's IP portfolio: the marketing bundle, the technical bundle and the information technology bundle.

Marketing Bundle	Technical Bundle	IT Bundle
Primary Trademark	Key Patents	Operating Systems
Corporate Name and Logo	Trade Secrets	Enterprise Solutions
Marketing Umbrella	Formulae	Custom Applications
Sub-brand Names	Packaging Technology	Data Warehouse
Worldwide Trademark Registrations	Manufacturing Technology	Data Mining
Copyrights	Product Specifications	Mailing Lists
Secondary Trademarks	Product Shapes and Sizes	Domain Names / URL's
Packaging Design	Proprietary Test Results	Third Party Software Tools
Trade Dress	Technical Designs	Certifications
Product Names	Drawings, Manuals	Source Code

Valuation context

The assets included in these bundles, along with the complementary factors, are not the only aspects of the context in which the intellectual property must be viewed. The current status and reasonable prospects for the owner/user of the property also must be considered when evaluating the value of the intangibles to potentially be used as collateral. Whether the company is a going concern or is undergoing reorganization will have a substantial impact on the IP value. Also, if the assets are to be sold, can they be marketed under an orderly disposal scenario, or is the context one in which the assets are to be liquidated immediately? Each factor will likely lead to a different outcome for the valuation analysis.

If a going concern, the value of the IP is determined by the ability of the intellectual property assets to capture market share and command premium pricing in the marketplace. These characteristics will depend upon the competitive nature of the industry and the company's relative competitive status, as well upon the existence of the complementary factors outlined above. The IP value in this situation is the price most likely to be achieved in an orderly disposition of the assets, one in which a fair price is negotiated between unaffiliated parties that are under no compulsion to act.

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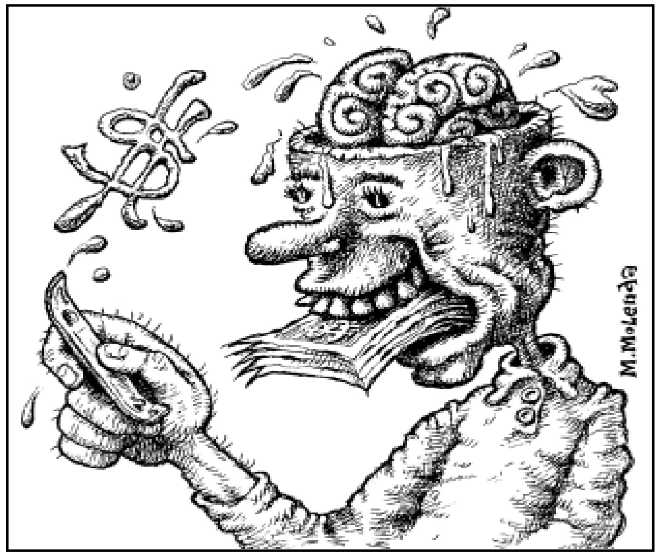
If the company is financially distressed, however, the value of the intellectual property will be negatively affected, even in an orderly disposition situation. The company's resources are restricted to a greater extent than normal and the company may feel compelled to accept a lower price than it would in a more normal operating environment.

When a company's resources are restricted, it may not have full access to manufacturing capabilities because of the lack of credit from contract manufacturers. It may not have the marketing and distribution resources available during more successful times. It may not be able to price its products appropriately, thereby resulting in lower profit margins than normal. Or it may not be able to provide the necessary level of support for its existing customer base. These severe consequences can jeopardize a company's competitive advantage, thereby resulting in lower sales volumes and lower margins. All of these events can have a significant impact on the value of the associated intellectual property.



The decline in asset values associated with a forced liquidation are well documented and easily understood. Lesser known is the extent of the decline that will be experienced by the intellectual property in a liquidation scenario. From experience, we have seen that assets that can be used in more than one industry, such as desks and trucks, tend to have a smaller liquidation discount than assets that are industry- or manufacturing-process specific. While this will depend on the competitive aspects in place at the time, generally assets with more bidders will receive a relatively higher portion of their "going concern" value than those with a smaller field of interested parties. The same holds true for intellectual property. In general, higher bidder interest translates into smaller liquidation discounts.

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Although there are many exceptions, technology assets such as patents, formulae and trade secrets generally hold their value better than marketing assets such as trademarks and brand bundles. The reason for the financial distress may also have an impact on the value of the IP. For example, if the financial distress is caused by out-of-control expenses, the value of the IP will likely be higher than if the financial distress is caused by a reduction in sales. Whether the target market is businesses or consumers also tends to make a difference in the impact on IP value. Businesses tend to rely more on their last interaction with the company while

(Continued on page 26)

CASE STUDY #1 - Acquisition/Bankruptcy (Rental Car Company)*		
Description	**Going-Concern**	**Liquidation**
Trademark Assets	$325M	$63M
Franchise Rights	82M	14M
Reservation System	38M	4M
Customer Databases	5M	2M
Airport Concession Rights	12M	0
TOTAL VALUE	**$462M**	**$83M**

CASE STUDY #2 – Bankruptcy/Reorganization (Major Film Company)*		
Description	**Orderly Disposal**	**Liquidation**
Total Technology Asset Value	$15.3 – 19.5M	$3.7 – 4.3M
Total Brand Asset Value	$30.8 – 45.2M	$6.7 – 7.8M
NET VALUE (after all hard costs)	**$46.1 – 64.7M**	**$10.4 - 12.1M**

CASE STUDY #3 – Liquidation/Asset Sale*		
Company:	Fiber optics company	
Context:	Liquidation of subsidiary	
Cause:	Massive potential tax benefit	
Components:	Eight independent fiber optics patent bundles Multiple trademarks	
Valuation Approach:	Components of value, liquidation value	
Going-Concern	**Liquidation**	
TOTAL VALUE	**>$5.0M**	**<$250,000**

a consumer's good first impression will often provide more breathing room for the troubled company.

All of these examples are matters of degree. The actual discount associated with forced liquidation will depend upon the specific factors associated with each case.

Case studies

Let's look at three different case studies, as well as the underlying cause and environment in which the intangible assets are being valued. In each case there were different reasons for the undertaking of the valuation. In the first case study, the company was in the midst of reorganization resulting from severe cash-flow difficulties and was entertaining offers to be acquired by one of its competitors. The company was looking to secure $100 million of interim funding to cover its short-term cash needs during the acquisition period. The assets identified in the due-diligence phase included trademark assets, franchise agreements, reservation systems and customer databases, among others. Once the consulting firm went through the valuation process, it was able to establish going-concern value, which was in excess of $450 million, versus liquidation value, which was just under $85 million.* See the Case Study #1 table.

The next case study involves a major film manufacturing company and the valuation of its trademark and brand assets. In addition, the consulting firm valued the patents and technology assets within the company, which included 800+ patents within 52 clusters, 30,000+ proprietary molecules, instant digital printing technology and various patent licenses. The value of the assets took place during the company's Chapter 11 reorganization and the focus of the work was to determine whether the value of the assets would be substantially greater in an orderly disposal, as opposed to an immediate liquidation. The value of the trademark and brand assets required knowledge of possible acquirers and competitors. As seen in the Case Study #2, the orderly-disposal values for the assets were in the $46 million-to-$65 million range, whereas the liquidation values were between $10 million and $12 million.* See the Case Study #2 table for additional information. Note that the values shown in Case Study #2 were net of hard costs of liquidation or disposal.

In the final case study, the consulting firm was asked to identify all of the intellectual property with value, to identify acquirers, and to sell the assets for a large fiber optics company in the midst of liquidating one of its subsidiaries. Working on a very tight time schedule, staff had to perform all of the valuation and disposition tasks prior to the end of the then-current calendar year. As a result, the consulting firm moved swiftly to identify and value the trademarks and other brand assets and also to identify the group of technology assets with value. In liquidating these assets for the parent company, the goal was simple: Dispose of the assets as quickly as possible,

(Continued on page 96)

Intellectual property valuation: Context is critical

(Continued from page 26)

without regard to maximizing cash from the sales. The reason: by disposing of the assets prior to year end, the company could then be eligible for a tax refund in excess of $10 million as reimbursement for development costs incurred. See the Case Study #3 table.

Conclusions

Identifying and understanding the value of intellectual property is complex. A number of critical factors must be considered to provide an accurate and useful valuation. The context of the valuation is critical in all cases and serves as the key value determinant. The context is determined, the bundles of assets can be identified and the correct valuation approach can be applied to ensure accurate results. Some key thoughts to take away include:

- ➤ IP valuation is becoming increasingly complex
- ➤ Value can change over time
- ➤ It is a nonstatic process
- ➤ Context determines value. ▲

** Names of case study companies have been withheld and actual results have been altered to protect client confidentiality.*