The Value and Management of Intellectual Property, Intangible Assets, and Goodwill

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Executive Summary

- Intellectual capital is recognized as the most important asset of many of the world's largest and most powerful companies.
- It is the foundation for the market dominance and continuing profitability of leading corporations.
- It is often the key objective in mergers and acquisitions, and knowledgeable companies are increasingly using licensing routes to transfer these assets to low-tax jurisdictions.
- Accounting standards have traditionally not been helpful in representing the worth of intellectual property rights (IPR) and intangible assets in company accounts.
- Future winners will be those who own and effectively manage intellectual capital, which asset—such as a brand, patent portfolio, etc.—has become possibly the most critical success factor. No sector has been untouched by IPR.

Introduction

The role of IPR in business is insufficiently understood. It is probably undervalued, undermanaged or underexploited, and there is little coordination between the different professionals dealing with an organization's IPR. You probably need to have a better understanding about intellectual capital and its ownership, acquisition, and use. You probably need a practical source of knowledge and guidance about intellectual property and other intellectual capital in a commercial context. You might be a chief executive of an intellectual capital company, or a brand-based business, or both. You might be a manager of such a business, or a research director, or academic. Maybe you are a student on a management program, or an accountant, a corporate finance professional, an investor, or a venture capitalist. In your studies intellectual capital will not have been a core subject. Whatever the reason, you need to understand intellectual capital, especially IPRs, to do your job better or to be more successful in your career. IPRs are both important and complex. Therefore the questions to be addressed are often:

- What are the IPRs used in the business?
- What are their value (and hence level of risk)?
- Who owns it (could I sue or could someone sue me)?
- How may it be better exploited (e.g. licensing in or out of technology)?
- At what level do I need to insure the IPR risk?

The Benefits of IPR Management

You cannot “manage” without having some understanding of value, and the benefits of good IPR management include:

- Increased returns on capital invested in the business, particularly capital tied up in intellectual property.
- Increased shareholder value.
- A thorough understanding of the alignment of intellectual property development or acquisitions and business strategic objectives.
- The ability to make informed decisions about intellectual property development or acquisition.
- The creation of new and diverse revenue streams from intellectual capital, and especially from underused intellectual capital.
- The ability to distinguish between valuable intellectual capital (perhaps within a large portfolio) and so protect it fully, and intellectual capital of no significant value, which might be sold or abandoned.
- Achieving lower overall costs associated with intellectual capital development or acquisition, protection, and utilization.
- Creating internal awareness of the importance of intellectual capital to success.
Current Big Issues for IPR Valuation

- Accounting standards.
- Corporate governance.
- Litigation (defence and attack).
- Fairness opinions.
- In-process R&D.

IFRS 3 Business Combination Valuation Allocations, IAS 38 Recognition of IPR in Accounts, and IAS 36 Valuation Impairment Tests

Purchase accounting must be applied to all acquisitions (business combinations are also treated as acquisitions, and there is no more merger accounting). Many intangible assets that would previously have been subsumed within goodwill must be separately identified and valued. Explicit guidance is provided for the recognition of such intangible assets, and IFRS 3 includes a list of assets that are expected to be recognized separately from goodwill.

The valuation of such assets is a complex process and nearly always requires specialist intellectual property (IP) valuation skills, and frequently an IP lawyer to undertake the categorization which the valuer requires. Examples of intangible assets to be separately recognized and categorized within the purchase cost are set out in the regulations and include those which are: marketing-related (trademarks, brands, domain names, newspaper mastheads), customer-related (customer lists and contracts), artistic-related (television programs, photographs, films, publications), contract-based (e.g. licensing and royalty agreements, contracts for numerous situations such as advertising, construction and supply), and technology-based (patents, computer software, databases, trade secrets, etc.).

IFRS 3 is mandatory for all new transactions from March 31, 2004.

Additionally, under IAS 36 valuations need to be independently tested for impairment by the valuer on a regular basis. Obviously one of the valuer’s first questions will be (with advice from the IP lawyer, or patent or trademark attorney): Has there been any diminution of the legal nature of the originally categorized IP?

Corporate Governance

Statute and case law is being developed which will compel boards of directors to accept that they must undertake and lead IP decisions rather than leave them to management.

- Sarbanes–Oxley: The provision of valuation services for audit clients is prohibited.
- Caremark International 1996 imposed on directors the duty to ensure adequate reporting.
- A Walt Disney case in 2003 and Research in Motion (the Blackberry case) establish the potential liability of directors in respect of IP.
- Find case references at www.valuation-consulting.co.uk/services/oxley_act.html

IPR and the Valuation Expert

For the valuer, this process of understanding is not usually a problem when these rights have been formally protected through trademarks, patents, or copyright. This is not the case with intangibles such as know-how (which can include the talents, skill, and knowledge of the workforce), training systems and methods, designs, technical processes, customer lists, distribution networks, etc. These assets are equally valuable but more difficult to identify in terms of the earnings and profits they generate. With many intangibles a very careful initial due diligence process needs to be undertaken together with IP lawyers and in-house accountants.

Overall risk affects valuation analysis; corporate valuation must reflect risk, and, most importantly, risk assessment should reflect IPR value.

One of the key factors affecting a company’s success or failure is the degree to which it effectively exploits intellectual capital and values risk. Management obviously need to know the value of the IPR and those risks for the same reason that they need to know the underlying value of their tangible assets; this is
because business managers need to know, or should know, the value of all assets and liabilities under their stewardship and control, to make sure that values are maintained. Markets (restricted or otherwise), institutions, and shareholders need to be educated. Exploitation can take many forms, ranging from outright sale of an asset, to a joint venture or a licensing agreement. Inevitably, exploitation increases the risk assessment.

The valuation procedure is, essentially, a bringing together of the economic concept of value and the legal concept of property. The presence of an asset is a function of its ability to generate a return and the discount rate applied to that return. The cardinal rule of commercial valuation is: the value of something cannot be stated in the abstract; all that can be stated is the value of a thing in a particular place, at a particular time, in particular circumstances. The questions “to whom?” and “for what purpose?” must always be asked before a valuation can be carried out. This rule is particularly significant as far as the valuation of intellectual property rights is concerned. More often than not, there will be only one or two interested parties, and the value to each of them will depend on their circumstances. Failure to take these circumstances, and those of the owner, into account will result in a meaningless valuation.

There are four main value concepts, namely, owner value, market value, tax value, and fair value. Owner value often determines the price in negotiated deals and is often led by a proprietor’s view of the value if he or she were deprived of the property. The basis of market value is the assumption that if comparable property has fetched a certain price, then the subject property will realize a similar price. The fair value concept is essentially the desire to be equitable to both parties. It recognizes that the transaction is not in the open market and that vendor and purchaser have been brought together in a legally binding manner. Tax valuation has been the subject of case law worldwide since the turn of the century and is an esoteric practice. There are also quasi-concepts of value which impinge on each of these main areas, namely, investment value, liquidation value, and going-concern value.

Methods for the Valuation of IPR

Acceptable methods for the valuation of identifiable intangible assets and intellectual property fall into three broad categories. They are either market-based, cost-based, or based on estimates of future economic benefit. In an ideal situation an independent expert will always prefer to determine a market value by reference to comparable market transactions. This is difficult enough when valuing assets such as bricks and mortar because it is never possible to find a transaction that is exactly comparable. In valuing an item of intellectual property, the search for a comparable market transaction becomes almost futile. This is not only due to lack of comparability, but also because intellectual property is generally not developed to be sold, and many sales are usually only a small part of a larger transaction and details are kept extremely confidential. There are other impediments that limit the usefulness of this method, namely, special purchasers, different negotiating skills, and the distorting effects of the peaks and troughs of economic cycles. In a nutshell, this summarizes my objection to such statements as “this is a rule of thumb in the sector.”

Cost-based methodologies, such as the cost to create or the cost to replace, assume that there is some relationship between cost and value, and the approach has very little to commend itself other than ease of use. The method ignores changes in the time value of money, and maintenance.

The method of valuation flowing from an estimate of past and future economic benefits can be broken down into four limbs: (1) capitalization of historic profits, (2) gross profit differential methods, (3) excess profits methods, and (4) the relief from royalty method.

Discounted cash flow (DCF) analysis sits across the last three methodologies. DCF mathematical modeling allows for the fact that one euro in your pocket today is worth more than one euro next year or one euro the year after. The time value of money is taken into account by adjusting expected future returns to today’s monetary values using a discount rate. The discount rate is used to calculate economic value and includes compensation for risk and for expected rates of inflation.

The capitalization of historic profits arrives at the value of IPRs by multiplying the maintainable historic profitability of the asset by a multiple that is assessed after scoring the relative strength of the IPR. For example, a multiple is arrived at after assessing a brand in the light of factors such as leadership, stability, market share, internationality, trend of profitability, marketing, and advertising support and protection.
While this capitalization process recognizes some of the factors which should be considered, it has major shortcomings, mostly associated with historic earning capability. The method pays little regard to the future.

**Gross profit differential methods** are often associated with trademark and brand valuation. These methods adopt the differences in sale prices, adjusted for differences in marketing costs. That is, the difference between the margin of the branded and/or patented product and an unbranded or generic product. This formula is used to drive out cash flows and calculate value. Finding generic equivalents for a patent and identifiable price differences is far more difficult than for a retail brand.

The **excess profits method** looks at the current value of the net tangible assets employed as the benchmark for an estimated rate of return to calculate the profits that are required in order to induce investors to invest into those net tangible assets. Any return over and above those profits required to induce investment is considered to be the excess return attributable to the IPRs. Although theoretically relying on future economic benefits from the use of the asset, the method has difficulty in adjusting to alternative uses of the asset.

**Relief from royalty** considers what the purchaser could afford, or would be willing to pay, for the licence. The royalty stream is then capitalized, reflecting the risk and return relationship of investing in the asset.

**Discounted Cash Flow Analysis**

Discounted cash flow analysis is probably the most comprehensive of appraisal techniques. Potential profits and cash flows need to be assessed carefully and then restated to present value through use of a discount rate, or rates. With the asset you are considering, the valuer will need to consider the operating environment of the asset to determine the potential for market revenue growth. The projection of market revenues will be a critical step in the valuation. The potential will need to be assessed by reference to the enduring nature of the asset and its marketability, and this must subsume consideration of expenses together with an estimate of residual value or terminal value, if any. This method recognizes market conditions, likely performance and potential, and the time value of money. It is illustrative, demonstrating the cash flow potential of the property, and is highly regarded and widely accepted in the financial community.

The discount rate to be applied to the cash flows can be derived from a number of different models, including common sense, the build-up method, dividend growth models, or the capital asset pricing model (CAPM), utilizing a weighted average cost of capital. This appraisal technique will probably be the preferred option.

These processes lead one nowhere unless due diligence and the valuation process quantify remaining useful life and decay rates. This will quantify lives such as the following, and which is the shortest: physical, functional, technological, economic, and legal. This process is necessary because, just like any other asset, IPR has a varying ability to generate economic returns that depend on these main lives. For example, in the discounted cash flow model it would not be correct to drive out cash flows for the entire legal length of copyright protection—which may be 100 plus years—when a valuation concerns computer software with only a short economic life span of one to two years. However, patent legal protection of 20 years can prevent infringement situations which may be important, as is often illustrated in the pharmaceutical sector where generic competitors enter the marketplace at a speed that dilutes a monopoly position when protection ceases. The message is that, when undertaking DCF modeling, never project longer than is realistic by testing against these major lives.

It must also be acknowledged that, in many situations, after these lives have been examined carefully to produce cash flow forecasts it is often not credible to forecast beyond, say, four to five years. The mathematical modeling allows for this by using, at the end of the period when forecasting becomes futile but clearly the cash flows will not “fall of a cliff,” a terminal value that is calculated using a modest growth rate (say inflation) at the steady state year but also discounting this forecast to the valuation date.

Valuation is more an art than a science and is an interdisciplinary study drawing on law, economics, finance, accounting, and investment. It is rash to attempt any valuation adopting so-called industry/sector norms in ignorance of the fundamental theoretical framework of valuation.

**Case Study**

IP financings can unlock value that markets and capital providers have overlooked. Tax-effective strategies concerning the management of IP, and the attendant ability for structures to provide attractive securitization
prospects, have become more widely known. As reported by Business Week in 2007, the largest ever IP-backed securitization, US$1.8 billion for Sears’ Kenmore Craftsman and DieHard brands, may be a harbinger of things to come for IP as an asset class.

Sears has disclosed that it created a “separate, wholly owned, bankruptcy-remote subsidiary”—essentially a company within a company. Called KCD IP (for Kenmore, Craftsman, DieHard, intellectual property), the entity issued US$1.8 billion worth of bonds backed by the intellectual property of Sears’ three biggest brands, according to filings with the Patent & Trademark Office.

Sears, in essence, created licensing income. First it transferred ownership of the brand names into KCD, which charges Sears royalty fees to license bonds to the insurance subsidiary, where, like any other security on an insurer’s books, it serves as protection against future loss. The insurer, meanwhile, protects Sears from financial trouble—and, because it is a subsidiary, it does so at a lower cost than Sears could get from an outside party.

The payments net out to zero because Sears owns every piece. But that would change if Sears were to sell the bonds to outsiders. Sears would be holding up to US$1.8 billion in case, and investors would be holding the bonds.

The KCD bonds have a higher credit rating than Sears’ regular bonds. Moody’s Investors Service gave KCD an investment-grade rating of Baa2, four rungs better than Sears’ junk rating of Ba1. How so? If Sears were to go bankrupt, bondholders wouldn’t be able to get their hands on Kenmore, Craftsman and DieHard trademarks, the company’s crown jewels.

Following this, Eric Hedman, a director in S&P’s Structural Finance Group, said “interest [in intellectual property deals] is exploding.”

Making It Happen

In the book I coauthored with John Sykes, an IP lawyer (Sykes and King, 2003), we established a number of general principles concerning the management and valuation of intellectual property:

- Make intellectual capital a part of the business’s strategic thinking and planning. For example, risk control, maximizing value, being aware of emerging technologies, seeking appropriate legal protection, etc.
- Understand the role of intellectual capital. This involves assessing the importance of intellectual capital now and in the future to the market position and future success of your business. Part of this is the challenge of identifying the intellectual property of others and avoiding infringement of the associated legal rights.
- Be aware of competing intellectual capital.
- Know your own intellectual capital. Use rigorous processes to identify and evaluate the existing intellectual capital in the business, creating a comprehensive record of results, and developing a process for identifying future IPR. Carry out positive due diligence. Success or not is dependent on a management process to do the aforementioned.
- Identify required intellectual capital, which is a process of forecasting future needs.
- Acquire any required intellectual capital.
- Think tax and balance sheet.
- Be ready to protect your rights.
- Measure improvements as an essential part of good intellectual capital management, to develop measures of success for the management and evaluation of IPR.
- Spread the message, because just as important as measuring improvements is communicating a strategy and a process, not least via financial PR, etc.
- Know the cost and value of your intellectual capital.
More Info

Books:

Articles:

Websites:
- American Society of Appraisers (ASA): www.appraisers.org
- *International Asset Management* magazine: www.iam-magazine.com
- International Valuation Standards Committee (IVSC): www.ivsc.org
- Society of Share and Business Valuers (SSBV): www.ssbv.org
- Valuation Consulting, the website of the author’s company: www.valuation-consulting.co.uk

See Also

Thinkers
- Warren Buffett

Finance Library
- Intellectual Capital: The New Wealth of Organizations

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