Introduction to IP Valuation

How much is your IP worth?

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As we move into an information age characterized by increasing competition and shorter product life cycles, companies are becoming increasingly dependent on their intellectual properties (IP). As a result, strategic decisions are increasingly dependent on understanding the economics affecting the value of these properties.

According to economic theory, the value of an asset is best determined by the market, in the form of a transaction between two unrelated entities dealing at arm's length. Unfortunately, intangible assets and IP that will eventually support products seldom benefit from open market conditions, either due to novelty or secrecy factors. In consideration of the growing investments required to develop and market products, there is a growing need for assessing the economic value of such IP as early as possible in the product development cycle. This is the topic of this short article.

Opportunity

Besides important corporate events, such as M&A, financing and to a lesser degree dissolutions, little time and effort is invested in assessing the value of intangible assets and of IP portfolios. This is especially true when IP is not aligned with the company's business mission, priorities or goals.

Value assessment is not an accounting operation but rather an attempt to reconcile information pertaining to a given IP or business project, such as development costs, expectation of income, comparative advantages and market data, for the purpose of making better strategic decisions. The valuation process can take into consideration the impact of IP not only on projects and products but also on the company's operation and on its competitive position as a whole.

Benefits of value assessment

Targeted valuation of IP, technologies and products can generate significant awareness and incremental value throughout the organization by helping companies to:

- Choose between market opportunities;
- More effectively protect and leverage the IP portfolio and important technology necessary to capture innovation and future growth;
- Develop a strategy for IP development and protection that is closely aligned with the company's overall strategic goals;
- Identify un-tapped value and revenue opportunities;
- Compare and select projects for the best allocation of the development budget;
- Better utilise the IP portfolio through various commercialisation avenues such as licensing, donation, joint ventures, divestiture, transfer to suppliers, set-up of subsidiaries, spin-offs, etc.
- Justify a return on investment for technology and patents;
- Reflect overall company value more accurately on financial statements.

Identifying intangible assets

The categories of intangible assets most commonly valued include:

- Industrial Property: patents covering products or processes, trademarks and service marks;
- Brands: marks, consumer goods, corporate names and identity;
- Copyrights: computer software, documentation of processes and business methods, etc;
- Publishing Rights: magazines, books, film and music rights;
- Licenses: television and radio, franchises, distribution rights; and
- Know-how.

Intangible assets protected by industrial property laws are documented and disclosed to the public. Valuable know-how are generally held as trade secrets within the organization and disclosed to licensees and partners confidentially.

For valuation purposes, the intangible assets must be readily identifiable, documented and capable of being separated from the other assets employed in the business. Intangible assets that exist but that cannot be specifically identified are included in goodwill. The intangible asset should generate some measurable amount of economic benefit to its owner; this economic benefit could be in the form of an income increment or of a cost saving.

Product value vs. patent value

The value of a product that is supported by a patent should not be confused with the independent value of the underlying patent(s). The value of a product is determined by its capacity to generate income. The value of a patent however, cannot extend beyond the added value it provides to the product. This added value can be estimated in short by segregating the percentage of a patented product's revenues that are directly attributable to the monopolistic position granted by the patent, specifically, the monopoly to sell products and processes covered by the patent's claims. Of course, all litigation and patent filing costs incurred to establish, maintain and defend this monopoly position should be subtracted from the patent revenues.

Patents offer an opportunity to "invest" - that is - obtaining patents and preventing infringement through litigation, in order to increase and/or secure a sufficient return on development and marketing investments. In that regard, industrial property rights can be compared to financial "derivative products" applicable to product development projects.

For the above reasons, the value of patents is generally much lower than the value of cash-generating products. Of course, the value of patents that cover fundamental concepts will exceed the independent value of any related product; these are unfortunately very rare cases.

Principal valuation techniques

Discounted cash flows, comparables, rules of thumb, auction, direct cost and opportunity cost are some of the common methodologies used to value intellectual property. Each method has its own strengths and weaknesses and should only be used when deemed appropriate for the intellectual property being valued or the particular valuation situation.

These methodologies must be understood within a conceptual framework, which is structured around three different methods:

1. The **Cost** approach, that is the cost to create or recreate the asset; we look at what we spent on developing the IP and what another company might spend if they were to invent it from scratch.

2. The **Market** approach, that is the sales of comparable intellectual property, where a "somewhat" similar deal could be used for the purposes of comparison.

3. The **Income** approach, which is based on the future economic benefits produced by the intellectual property; where we look at the projected incremental profits or cost savings from using the IP.

The cost approach is based on several economic principles such as the principle of Substitution (a prudent buyer would pay no more for an intellectual property than the cost to construct or develop an asset of equal desirability and utility), the principle of Externality (external conditions may cause a newly constructed intellectual property to be worth more or less than its original cost), the principles of Functional, Technological and Economical obsolescence (the value of the asset may be reduced by its inability to perform a function for which it was designed, or by competing technology which makes the asset less than the ideal replacement for itself, or by external considerations such as economic cycles), and finally the principle of shifts in supply and demand.

In the absence of a buyer-seller or a licensor-licensee relationship, the valuation process using the market approach seeks to reproduce the context in which a transaction would normally take place in an open market. A survey of the information available on transactions made by publicly traded companies in a field or industry similar to the valued IP is generally performed. Because transactions on comparable IP can be structured in different ways, the research and development of comparables and metrics, particularly for royalty rates, remains complex and time-consuming.

The various income valuation methods may be grouped into two analytical categories: Direct Capitalization and Discounted Future Economic Benefits. In a direct capitalization analysis, the appropriate measure of economic income for one period is defined and divided by an appropriate investment rate of return (called the capitalization rate), which may be derived from the expected useful market life for the IP. In discounted future economic benefits analysis, the appropriate measure of economic income is projected for several time periods in the future. This projection of prospective economic income is converted into a present value by the use of a present value discount rate. This discount rate is consistent with the rate of return that would be required by an investor over the expected term of the economic income projection.

While any one of the three valuation approaches can be used to provide a reliable value estimate, it is generally advisable to compare the result obtained by two methods for the purpose of challenging the results. The value provided by each method should be different; it can also be significantly different. No methodology can be equally pertinent however to the particular IP situation under analysis.

A diligent valuer should therefore base his opinion on the value provided by what appears as the more reliable methodology, to the extent of discounting the value by a factor reflecting the qualitative and quantitative contribution of the second best value.

The process of assessing the economic value of products, technologies and IP is one which is only useful during the commercial phase. It is also useful all the way up, at every phase of turning an idea into a development project and ultimately, a product.

Conclusion

IP Valuation is not a science, but an external judgment based on heterogeneous information pertaining to the IP, to the product(s) that will carry the IP and to the market in which the products are sold. The subjective nature of the valuation exercise should be balanced by the use of the most reliable data, within the framework of a rigorous valuation methodology.

Because of the increasing importance of IP in a company's valuation, turning ideas and innovation into profit is and will continue to be the biggest challenge and the greatest reward of companies in the information age. For a growing majority of companies, strategic decision-making is becoming depending upon the early assessment of IP value and the understanding of the economics affecting value.

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High Spin assists large corporations, research centers, SME's and individual inventors with regards to technology transfer, intellectual property licensing, IP valuation and IP management projects.

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