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Valuation & Strategies for the Sale of Intellectual Property

Wisconsin IP Law Association

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Agenda

- Introductions
- Discussion framework: IP purchase (patents) from the Buyer's perspective
- Review of Buyer's motivation for acquiring the assets and its impact on valuation
- Detailed review of key valuation issues and modeling techniques
- Q & A

“How much is it worth?”

- Is my IP worth as much as I think it is?
- How do you determine how much IP is worth in a merger or acquisition?
- What do you do when the bidding price and the asking price is really far apart for IP?
- During a merger or acquisition, how does a company determine if they should spin-off the IP or sell it together in the deal?
- I have an offer to license or buy my IP – what’s the better deal?

The Buyer's Motivation

- Purchase the underlying technologies and know-how, along with the legal protections afforded by the claims in the patent(s)
 - Often part of a plan to commercialize the technologies (“**Enabling**”)
- Purchase only the patent and legal rights
 - Often part of a “Freedom-to-Operate” strategy, or
 - As a strategy to preclude competition (“**Blocking**”)

The Buyer's Motivation Impacts Valuation

- Different strategies require different techniques, models, value drivers and data
- **Enabling** strategies strive to measure internal benefits to be recognized by the Buyer's commercialization efforts (SFAS 141R/142)
- **Blocking** strategies strive to measure the benefits that could be garnered by competitors (SFAS 157)

Background

- Present a framework of IP valuation based on:
 - Valuation techniques accepted by the IRS, SEC, the courts and investors
 - Years of theory and practice
 - Open air, not black box methodologies

Enabling IP Acquisitions: Approaches to Value

- There are many valuation methodologies used to value IP, including:
 - **Income Approach**
 - **Market Approach**
 - **Cost Approach**

Enabling IP Acquisitions: Approaches to Value

- **Income Approach** - a technique by which value is estimated from the amount of cash flow that the asset is expected to generate over its useful life
 - Relief from royalty
 - Excess earnings
 - Cost savings

Enabling IP Acquisitions: Approaches to Value

- **Market Approach** - a technique by which Fair Value can be estimated from prices paid in actual market transactions and from asking prices for similar assets, which are available for purchase
 - Not often used due to lack of data and comparability of transaction
 - There have been some IP auctions, information is not publicly available

Enabling IP Acquisitions: Approaches to Value

- **Cost Approach** - considers the current cost of reproducing the asset
 - Usually gives you a minimum value
 - Most often used for non-income producing assets

Income Approach: *Relief from Royalty*

- Relief from royalty – an income approach that measures value based on the premise that by owning the asset the business does not have to pay royalties for the rights and privileges to use it
 - One of the most widely used methodologies
 - Captures the value to the current holder if they had to license it, but does it represent the value of the asset to other market participants?
 - What about the value to others?
 - Calculations not difficult, but assumptions require thorough analysis and documentation
 - Key assumptions include:
 - Royalty rate
 - Revenue stream
 - Cost of capital

Income Approach: *Excess Earnings*

- Excess earnings - an income-based approach most often used to value customer relationships
 - Estimates future sales and cash flow from the current customer base
 - Accounts for the expected attrition of the current customer base
 - Accounts for a normal return on all of the assets employed

Income Approach: *Cost Savings*

- Cost savings - looks at the cost to produce an item with and without the owned technology
 - Estimate the operating profit differential between producing the product with and without the technology
 - Estimate the relevant period over which the competitive advantage will exist
 - Cost savings method may also be used to value a brand name by comparing the profit margin for the branded product to the profit margin for an unbranded product

Blocking IP Acquisitions: Approaches to Value

- Blocking strategies strive to measure the benefits that could be garnered by competitors
 - It is the inverse of a disgorgement of an ill-gotten gain damage model
 - Consistent with Georgia Pacific's use of a "hypothetical licensee"

Blocking IP Acquisitions: Approaches to Value

- Blocking strategies strive to measure the benefits that could be garnered by competitors
 - Valuation model will often be based on market-share analyses:
 - Specific claims mapped onto specific products or product lines
 - Approach referred to as a “TAPS Analysis” (Technology Applied to Problem Solved)
 - Now reflected in SEC’s “Market Participant” definition of Fair Value

Emerging Valuation Issues

- Some emerging issues that affect IP and its value include:
 - FASB 141R
 - Market based balance sheets
 - Need for proper management of IP
 - Patent monetization efforts

Key Issues

- Long-standing accounting practices are being changed
- This may result in earnings volatility
- Corporate staffs will require a greater understanding of Fair Value
- Will require greater collaboration/communication between CFO and other groups, such as the IP Department
- Generally, IP is only put on the balance sheet as part of an acquisition

Marketplace Disclosure Issues

- Both SARB-OX and SFAS 141 and 142 create complicated competitive issues by forcing companies to divulge IP asset values they might prefer to keep secret
- Hence, companies have to balance the need to protect their proprietary information against the disclosure requirements
- DILEMMA: The law may outweigh good business judgment

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Open Discussion



Appendix



Example – Relief from Royalty

**ABC MANUFACTURING COMPANY
VALUATION OF TECHNOLOGY (000'S)**

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Net Sales					
Product Line A	\$ 653,395	\$ 588,056	\$ 411,639	\$ 205,819	\$ 102,910
Products Line B	12,000	16,000	21,000	23,000	23,000
Products Line C	99,100	159,080	80,400	60,000	
Products Line D	27,594	27,594	27,594	13,797	
	<u>\$ 792,089</u>	<u>\$ 790,730</u>	<u>\$ 540,633</u>	<u>\$ 302,616</u>	<u>\$ 125,910</u>
Appropriate Royalty Rate (1.5%)	1.50%	1.50%	1.50%	1.50%	1.50%
Royalty Savings	11,881	11,861	8,109	4,539	1,889
Less: Income Taxes (39%)	4,634	4,626	3,163	1,770	737
Net Royalty Savings	7,248	7,235	4,947	2,769	1,152
Present Value Factor at 20.6%	0.9106	0.7551	0.6261	0.5191	0.4305
PV Net Royalty Savings (Rounded)	<u>\$ 6,600</u>	<u>\$ 5,463</u>	<u>\$ 3,097</u>	<u>\$ 1,437</u>	<u>\$ 496</u>
Totta PV Net Royalty Savings	<u><u>\$ 17,093</u></u>				
$V=(PV*L)/((L-(Fa*T))$					
Total Net Profit (PV)	\$ 17,093				
Remaining Tax Life (L)	15				
Taxes (T)	38.8%				
Amortization Factor (Fa) (15 years @ (12.1%))	1.23				
Value Indication (V) - Income Approach	<u><u>\$ 20,988</u></u>				
FAIR VALUE - TECHNOLOGY (ROUNDED)	<u><u>\$ 21,000</u></u>				



Example – Cost Savings

5 year life
 30% decrease per year
 14% Cost of Capital

Per unit	ABC	Competitor
Sales price	\$ 1.000	\$ 1.000
Cost of Sales	0.225	0.250
Gross Profit	0.775	0.750
SG&A	0.400	0.400
Operating Profit	0.375	0.350
Tax at 40%	0.150	0.140
after-Tax	0.225	0.210
Differential	0.015	
Sales Volume	10,000,000 units	
Cash flow	\$ 150,000	

	1	2	3	4	5
Cash Flow	\$ 150,000	\$ 105,000	\$ 73,500	\$ 51,450	\$ 36,015
Discount Factor	0.9366	0.8216	0.7207	0.6322	0.5545
Present Value	140,488	86,264	52,969	32,525	19,972
Net Present Value	332,218				
Rounded	\$ 330,000				

