

A general guide to the valuation of Intellectual Property

Introduction

Intellectual property rights and other intangible assets have the potential for creating enormous wealth. However, the challenges in proving ownership and of securing a robust revenue stream from exploiting IP can be greater than when dealing with tangible assets (e.g. land, stock, machinery etc).

What is IP?

When valuing IP a distinction can be made between:

- classic intellectual property rights, such as patents, copyrights, trade marks, registered designs, and design rights, all which are recognised in law as property in their own right; and
- the commercial value associated with other intangible assets such as goodwill associated with brands, access to know-how, to research and development capability, access to trade secrets. Most of these rights can be legally protected in some way (such as through the law of confidentiality, passing off etc) but the method of protection and treatment in law differs.

Any individual component (but more commonly a combination of these) may account for a significant proportion of the total value of a business.

Why value IP?

There are many reasons why businesses may want some or all of their IP to be valued. The nature of the IP and the reason for the valuation (and who wants it) may affect the valuation method adopted.

Some of the reasons include:

- **Protecting Directors against future claims.** Directors may need to prove that they have not transferred IP contrary to their legal duties as directors. Independent valuation can be extremely useful to prove that transactions were not made to avoid the claims of creditors or were not unfairly prejudicial to minority shareholders.

- **Accounting for your assets.** Periodic audit of IP is a vital part of managing key assets. You should know what you own and its value.
- **Calculating share values.** Assessing the value of IP may be needed when selling or purchasing shares.
- **Fund raising.** Valuation may be useful or required when arranging a grant, a loan, or offering or taking security over IP.
- **Fair Joint Ventures.** Assessing the value of IP contributed to a joint venture or other strategic alliance may be used to argue a case for a fair allocation of contribution, risk and reward.
- **Preparation of annual accounts.** An IP valuation may be needed in order to demonstrate a "true and fair view"
- **Commercial due diligence.** Are you paying too much or asking too little for the shares or assets of a company for sale? What is the IP really worth and can it be enforced?
- **Prospectus preparation** on Listings and Flotations.
- **Avoiding misrepresentation, FSMA breach and similar claims.** Whenever raising finance you have to be scrupulous in order to represent the true position. Valuation can assist in proving that your statements were true or reasonably held.
- **Fair allocation of development costs within group cost centres.**
- **Forensic accounting.** IP valuation may be needed to prove loss and damage in litigation.
- **Tax Generally.**

Often IP needs to be moved from the ownership of shareholders and or directors into a trading company, or from one group company to another. Often IP is moved to a holding company (frequently offshore) then licensed back.

This movement can **inadvertently trigger hefty tax charges**, which could prove very expensive to those involved at both shareholder and company level. Valuing the IP at the time of transfer is a vital part of tax planning.

- **Tax For multi nationals:**
 - There can be serious problems if issues of **transfer pricing** come into play. Transfers and licences must be at arms length between group companies.
 - Valuing the IP is a first step in preparing those arms length licences and in establishing appropriate transfer and royalty rates.
 - When **creating new subsidiaries or setting up contract research and development in overseas subsidiaries** or when **allocating R and D costs** between various subsidiaries, **care needs to be taken** to ensure that:
 - head office owns the resultant IP;
 - that appropriate control measures are established and recorded;
 - and consideration is given to the reason for and amount of any licence income stream from subsidiary to head office.

Providing an evidential valuation trail is vital to show such transactions have taken place at market value and where appropriate for claiming double taxation relief in the event taxation is also charged in other jurisdictions outside the UK where the tax treatment may differ.

Issues and concerns

Even though IP is often cited as a valuable asset, there remains a degree of scepticism as to whether value can be measure accurately and reliably. The fact that something may be difficult to value is not an argument for not valuing IP.

In order to value IP reliably, the risk factors and the profitability of the use of the IP once it is acquired, need to be considered. For example, when contemplating the purchase of a business as a going concern, the purchaser should assess:

- the title to the IP (i.e. you need to check the chain of title and the legal rights to own or use it);
- is the IP valid? The fact that a right is registered is not a guarantee that the right is validly registered. It may be valueless if invalid. This point should be carefully assessed by a lawyer as part of a valuation exercise;
- is the IP being infringed? If so, how widespread is the problem and how easy is it to stop any infringement?
- whether the cost of obtaining and maintaining any intellectual property and the associated legal rights can be justified;

- the likely costs of enforcing any rights in the intellectual property (i.e. taking infringement action). Costs will vary according to the historic quality of the IP management.
- Exactly how the IP creates value or provides strategic advantage within the target business and whether it generates its own revenue stream.
- whether the relevant IP really does save costs or curtails competition ?

Valuation is a team exercise

Valuation opinions ought to be independent. An internal assessment may cut little ice with the relevant authorities if it is ever needed to prove a point. Equally, a valuation exercise should not be taken without proper input from those who know the market in which it is used. Managers who undertake DIY valuation exercises (i.e. they do not seek an independent view) make a false economy.

Any valuation exercise should not be undertaken by valuers in isolation from a proper investigation of title and a validity assessment by specialist Intellectual property lawyers. Value has no meaning if you do not own the rights or have no way of adequately enforcing them. This is not simply a question of checking a few registers.

Methods of valuation

The International Accounting Standards Board (IASB) has concluded, that in the majority of cases, sufficient information will exist to reliably measure the IP of a business.

The fundamental principle of valuation is the theory that *the value of any asset is the present value of the future economic benefits that can be anticipated to accrue to the owner of that asset*. Although this statement is widely accepted there is no universally accepted method of valuation.

There are, in fact, a variety of methods, each with advantages and disadvantages. The choice will depend upon the nature of the IP and why it is being valued. There is a major difference in attempting to assess the value of all of the IP in a given business, rather than a single component part e.g. a single trade mark or patent. This is because it is often hard to treat such items in isolation. A patent may not be as valuable without access to relevant know how. A brand may piggy-back and derive its market reputation off the reputation and value of other brands owned by the same company, or the owner's name. The design of a product may be closely related to its trade mark.

Market Comparables Approach: This values the asset based on a comparison with sales or licences of similar assets.

Issues:

- IP is advantageous because it is based on something scarce, (occasionally it is monopolistic) and by its very nature will often be very individual in character. Therefore, it can be difficult, if not impossible, to find sufficiently detailed publicly available information on comparable sales of similar assets.

Replacement Cost Approach: This values the asset by accumulating the costs that would currently be required to replace the asset. In other words, a rational investor would pay no more than what it costs to replace the asset.

Issues:

- Whilst this method may be suitable for assets not directly generating income, businesses should be aware that cost is not always a reliable guide to value. For instance, where large amounts of money have been spent on research projects that have come to nothing they may have no present or future value to the company.

Cost Savings Method: This values the asset by calculating the present value of the cost savings that the business expects to make as a result of owning the asset

Issues:

- Although businesses can calculate savings from the introduction of new IP (such as a process or technology), it can be difficult to estimate whether a third party would save costs if the same process or technology was introduced into their business. Also, if the IP owner has adopted a strategy of licensing its IP rather than working it itself, there may be no manufacturing infrastructure in the licensor's business against which to measure a cost saving.

Royalty Stream Methods: There are two species of this method, savings and earnings.

- **The savings method.** This values the asset based on the present value of the royalty stream that the business is *saving* by owning the asset.
- **The earnings method.** This values the asset based on the present value of the future royalty stream that the business *expects to earn* by owning the asset.

Issues:

- Even though licensing of IP is very common, details of royalty rates are rarely made public and determining the appropriate rate is key to the valuation. There are some surveys of licensing rates by market sector, but they are historically quite dated and have fairly wide ranges of royalties quoted.

Excess Operating Profits Method: This values the asset by capitalising the additional profits generated by the business owning the IP over and above those generated by similar businesses (that do not have the benefit of the relevant IP).

Issues:

- Obviously you need a profit stream to assess or predict and the ability access financial data on comparable companies. The excess profits identified must be specifically attributable to the IP in question.

Inevitably the business which is used as a comparator, is likely to have a variety of IP assets of its own. This factor could mask the apparent excess profits, so several relevant comparisons may be needed to validate this method.

Single or Multiple Methods: Realistically, few approaches to valuing the IP can be consistently applied and it is common for a hybrid of approaches to be used, although some of the above methods are best suited to certain IP assets than others. For example, with patents the market comparables approach may not be suitable given that patents are inherently unique by definition.

Professional Assistance: Provided that the appropriate methodology is selected and properly applied, the value of IP can be reliably measured. However, assessing the value of the IP is not easy and requires professionals who are familiar with the particular subject and market area.

How we can help

We are normally able to suggest sources of professional independent valuation services appropriate to the circumstances.

Whilst Ashfords does not put figures on specific IP assets (i.e. we do not say to our clients that a given patent is worth £X), we do assist and work with our clients and other professionals covering the legal aspects of valuation exercises. For example, identifying the rights, assessing validity, checking the rights to own or use the IP and we prepare the appropriate legal documents to properly record the position to protect our clients' interests.

If you would like further information on IP matters generally please contact:

Mark Lomas on 0870 427 3951 or e-mail him at m.lomas@ashfords.co.uk

or visit our website
www.ashfords.co.uk

Disclaimer: The information given in this guide is intended to provide background awareness of some of the reasons for conducting a valuation exercise, some methods that can be used and the challenges associated with realistic IP valuation. It is not a comprehensive guide. It is not to be relied on either as legal taxation or valuation advice, nor as an alternative to taking professional advice relating to specific circumstances. Ashfords excludes all liability whatsoever for any loss or damage arising or claimed to arise out of use of this note or reliance on the information given in it.