

VALUATION ISSUES IN LICENCING

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APRIL 12, 2002

This little paper is directed at providing guidance to lawyers whose clients are selling or acquiring rights to intellectual property or other intangible assets. These transactions frequently involve the granting of a license to market or use the property for a specific or indefinite period. The principal focus of my comments is on those properties that have yet to prove their commercial viability.

Valuation issues, with respect to mature technologies with established track records that demonstrate a capacity to contribute cash flows, are usually able to be valued using the conventional techniques of discounted cash flows or market capitalization.

Lawyers do not (and should not) prepare the valuation calculations nor do they always advise their clients on the business aspect of the transaction. This paper will suggest that an important value-added service could be provided to most clients, whether they be vendor or purchaser, by lawyers who understand the valuation underpinnings of the transaction on which they are advising. The motivation for doing so is not only to improve service to the client; it is also in the lawyer's financial interest. These transactions tend to be complex and time consuming; if they are not supported by proper valuation and business imperatives, fee difficulties can arise.

At the end of this paper I have included a cursory overview of the valuation techniques currently applied by professional business valuers. A useful, in depth analysis of this topic is to be found in the book by Mr. John T. Ramsay, QC, *Technology Transfers and LICENCING*, Butterworths, Toronto. The focus of this paper, however, is to alert the lawyer to the subjective underpinnings of value as opposed to providing a series of models for quantifying that value. In my experience this critical, common sense evaluation of the business and economic underpinnings of the property being bought or sold is, almost without exception, short changed. Otherwise reasonable projects are thereby doomed to failure by the rush to access equity financing.

FUNDAMENTALS

When valuing an intangible asset it is essential, at the outset, to distinguish between commercial and non-commercial value. The latter concept embraces those transactions that once may have no future, continuing financial consequences. Examples are consumption expenditures for apparel and entertainment, and even luxury items such as automobiles and boats, where the

ultimate resale value is subsumed to the initial consumption benefit. The characteristics of intellectual property must be examined to ensure that there is indeed economic consequences to its possession. Non-commercial goodwill is irrelevant to the valuation of intellectual property licenses.

The classical definition of value is that of “fair market value”. This concept is summarized as “the highest cash price at which informed willing parties will transact in an open marketplace on a particular date”. It has been said that this definition of value is “preferred by some judges all of the time and all of the judges some of the time”. Interestingly, it is a concept that tends to be studied more at the end of a business relationship than at the beginning. Much of the learned valuation writings are based on judicial pronouncements, inevitably made after the business has ceased when there is either a dispute to be settled, taxes to pay or other problems.

Nevertheless, the classical definition provides useful insights into the valuation of an intellectual property transaction. First, the concept is one of an exchange of cash. This concept is important to bear in mind when valuing a property exchanged for shares or other non-cash property. When the consideration is non-cash, the parties are usually excessively casual about value issues.

A second essential element of the fair market value determination of intellectual property rights is that the rights must be actually transferable from one party to the other: the recipient organization has to be able to commercially benefit from them. In this sense, the classical concept of an open and unrestricted marketplace as being fundamental to the fair market value determination must, in the case of the transfer of intellectual property rights, be modified. Such rights, without exception, dictate the need for certain characteristics in the acquirer. For instance, the code to automate stock trading is valueless in the hands of anyone but another stock exchange that wishes to automate.

The determination of fair market value is a notional concept: it does not require the identification of specific purchasers. The valuation of intellectual property rights, particularly in the context of this paper, represent real world transactions. If the vendor has failed to identify, in a very specific way, who the purchasers and, if different, the end users are, it is possible that the rights will have little or no value.

There must be a discernable economic advantage to the acquirer of the property. Although seemingly trite, this obvious requirement is frequently overlooked by LICENCORS.

Examination of the economic advantages start with the net cash projected to be received by the LICENCEE. That advantage, measured either by its ultimate expected sale proceeds or by the periodic income net of expenses generated from its regular use, is compared with the upfront or periodic royalty cost to the

acquirer. This understanding is just as important to the LICENCOR-vendor as it is to the LICENCEE-purchaser because it should prove impossible to market a non-viable business proposition.

The second aspect of the economic advantage is the timing of revenue receipts. Some products, particularly bio-technology properties may take many years before they produce sales, let alone recovery of the costs of researching, developing and marketing the product. The value of the property is dramatically affected by the timing of periodic cash in-flows.

Finally, a skilled assessment must be made of the risk that the cash in-flows predicted for a particular intellectual property will in fact occur. The multiplicity of factors included in that decision go far beyond the quality of the technology itself or, even, its apparent utility to the intended marketplace.

The final issue under the value imperatives section is that of exclusivity. Paradoxically, this factor is of limited concern at the outset of the development of a new product or service. Many vendors in that position secretly wish for some competition to demonstrate the viability of the concept. If, however, the intellectual property does in fact demonstrate its commercial viability then its owner will wish to do all possible things to preserve that exclusive ownership in order to, among other things, license it to others. Accordingly, competent legal advice is critical to setting things up at the outset rather than awaiting the emergence of a competitor and attempting to resolve the matter through expensive litigation.

Legal advisors should be aware that, by the time that the entrepreneurs-LICENCORs come to their offices for the purposes of "papering the deal" will, by that time, have become addicted to the concept and will, long ago, have ceased to question its acceptability, marketability and profitability. The time that a legal advisor spends reviewing the subjective fundamentals of the property that is the subject of the transaction will be richly rewarded by either introducing some reality into the hopes of the LICENCOR or, more positively, suggesting additional prerequisites to be performed by the LICENCOR. All too frequently, the lawyers and other advisors are engaged after critical financing deadlines have been set and the entire thrust of the engagement is to produce reports, documents and exchange filings. The fundamentals are skipped over.

ORGANIZATIONAL ISSUES

There are numerous indicia which, when present, indicate the probability of asset value or otherwise. These include the following:

Cash Spent by the Vendor

Although it is true that the fact that a vendor has spent a lot of money developing an intellectual property does not necessarily equate to its having value: the concept might be unworkable or nobody else might see the use of it. But the opposite is almost universally true: if there has not been a material investment in the property, then it is likely that the intellectual property has minimal value. One reason for this phenomenon is that, absent the necessity of making substantial hard dollar investments in the project, the acquirer could merely hire the people to develop those projects within his own organization and thereby avoid the initial capital costs. Actual expenditures continue to be of significant interest to stock exchanges: CDNX currently requires evidence of expenditures in excess of \$1 million as a threshold for listing on that Exchange. Obviously, “expenditures” include only those external to the organization and will exclude “deemed” remuneration for personal time and effort spent by inventors and others.

In short, it is the presence of external expenditures that indicates value is there, although it may not be the determinant of that value.

Capacity to Exploit the Technology

It is critical that the organization acquiring the technology has the ability to use it to economic advantage. A technology that is compatible with existing business and technological structures and that can be seen to enhance those pre-existing entities will be more valuable than obtains in a situation where the vendor is hoping that new organizations will come into being for the purpose of using the technology at a profit.

One of the most dramatic examples of this phenomenon is the relationship between IBM and Microsoft. Although not always friendly, the corporate cultures of those two massive organizations have become very inter-dependent.

Customer Base

The vendor of intellectual property must identify not only potential purchasers but also the end users when they are not the same. This aspect of the plan is especially important in situations where the end user is a consumer requiring a huge investment in marketing and distribution. The valuation of the technology must be set at a figure that gives not only the vendor a return but the intermediary an adequate reward after all of the costs and risks of marketing and distribution.

Supplier – Labour Reliability

The transition of the utility from vendor to purchaser inevitably requires some support from the vendor, both initially and, perhaps again at the retooling stage. The organizational stability of the vendor is of paramount importance to the purchaser and the lack of same will seriously impact the value.

Again, Microsoft provides a useful example of the importance of customer support. That company has invested millions of dollars in providing technical support for all of its products. If one has the patience and money, Microsoft technicians will eventually solve almost all consumer problems.

Market Research

A critical component of the valuation issue is market research and feasibility studies. These can be quite expensive and LICENCORs frequently ignore them or try to do them on their own in an amateurish fashion. Quite simply, such studies can provide essential insights into whether the end users want the product or not and what their expenditure thresholds will be.

Such studies are necessary even when the LICENCOR hopes to market his intellectual property through intermediaries or wholesalers. To be convinced that they should commit resources to the marketing and distribution of the product, wholesalers need to be convinced of the existence of a marketplace. This aspect of the matter becomes especially important when “worldwide rights” are being touted as providing the basis for an optimistic reception.

In examining many such products I have seen minimal attention paid to this very important topic. Amusingly, in one of the few cases where a feasibility study was done, its results were ignored!

Financing

The post-development survival costs of intellectual property start-ups are huge. If the party in whose hands the intellectual property is being valued does not have access to significant amounts of cash, it is probable that the property has little value. Although it is true that some projects which wither due to lack of financing can become resuscitated in the hands of others, I have found this result to be rare indeed.

A startup organization that is counting on sales to fund research and development, marketing and distribution efforts, is virtually certain to fail. Projected sales, costs and collections are notoriously optimistic in this area.

The business plan, if credible, will be specific as to the amounts needed, and the source of those amounts.

Valuation Alternatives

The methodologies applicable to valuing intellectual property rights are little different, in principle, than assigning a value to other business interests. It involves three components:

- An estimation of the future cash flows (or savings) expected from the property rights;

- Determining the risk of not receiving all of the projected cash flows and expressing that risk in terms of a discount or capitalization rate; and
- Calculating the actual expenditures incurred in the development of the property.

DISCOUNTED CASH FLOW

Discounted cash flow (“DCF”) is the technique of calculating the up front consideration for a specified number of future receipts. For example, if the appropriate interest rate is 10% per year, you would pay \$90 today for the right to receive \$100 in one year’s time.

When the future income streams are relatively stable and certain, and when they will continue for a specified time period, then a discounted cash flow approach is entirely appropriate. Property leases are typically valued using this approach.

Discounted cash flow techniques, however, are seldom very useful in assigning a value to startup situations. Typically the early stage forecasts are optimistic due to financing and operational delays and projections beyond a two or three-year period are so uncertain as to be meaningless.

PRIOR EXPENDITURES

The cost method of valuing intellectual property is obviously suspect as a determinant of value. It does, however, have a couple of useful elements. First, stock exchanges give considerable weight to the cost factor. Second, it provides insights to the buy-or-build decision. And, as noted above, in the absence of material cash investment, the property is very unlikely to have a material value.

In order to have any utility, the cost calculation must be restricted to actual cash outlays; payments to inventors and principles must either be excluded or segregated.

CAPITALIZED EARNINGS

Valuation by the capitalized earnings approach is accomplished by applying the reciprocal of the interest rate appropriate to the business interests being valued to the annual after-tax earnings of the interest or enterprise. If, for instance the appropriate interest rate is 10%, the reciprocal, called the earnings multiple, is 10 times. If the earnings are \$50,000 the application of a 10 times multiple yields a (present cash) value of \$500,00. It is analogous to the familiar Price/Earnings ratio reported by publicly traded companies.

This valuation method is inappropriate in the absence of a sustained historical earnings stream; it will seldom be encountered in start-up situations.

COMPARATIVE MARKETPLACE

The importance of this technique is frequently under utilized in the valuation of intellectual property rights. Although comparison with other organizations would

appear to be irrelevant in circumstances where the property is unique and proprietary, useful insights obtain from examine the revenue potential or cost savings obtainable from competing properties. If the economic advantages are not clear and unequivocal, then it is likely that there is no value to the property. And, when the advantages can be reliably calculated, the results give a reasonable indication of the maximum value of the property.

The comparative market approach is also critical when valuing a product where the end users are consumers. It is doubtful that Linux would enjoy the popularity that it does among geeks if its licence cost was higher than Windows.

RUNNING ROYALTY AND STRATEGIC PARTNERSHIPS

This approach involves a pay-as-you go arrangement. The parties negotiate a basis for the royalty: typically a percentage of the product selling value or the pre-agreed cost savings and payment flows from LICENCEE to LICENCOR after the fact.

The arrangement has the very considerable merit of removing most of the risk assumed by the purchaser, a circumstance that should reasonably be expected to reward the vendor with a somewhat higher return