IP and Finance
- Accounting and Valuation of IP Assets and IP-based Financing -

– Topic 13 -

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Training of the Trainers Program on Effective Intellectual Property Asset Management by Small and Medium Sized Enterprises (SMEs)

Organised by the World Intellectual Property Organisation (WIPO) and the Business and Property Registration Agency (BPRA), Revolutionary Government of Zanzibar

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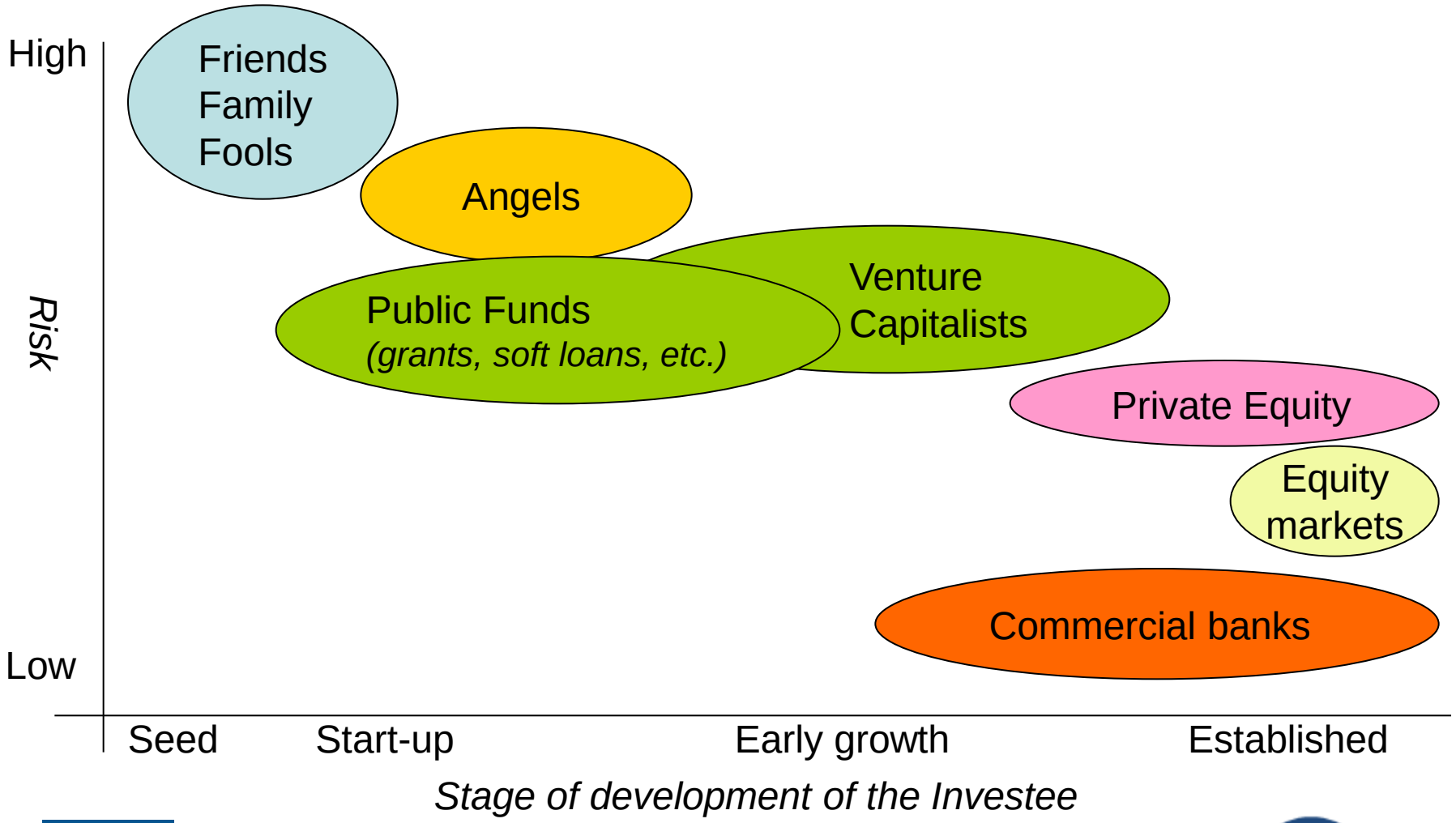
Presentation Outline

- Introduction
- Valuations
- Concluding Remarks

Introduction

Different Forms of Finance



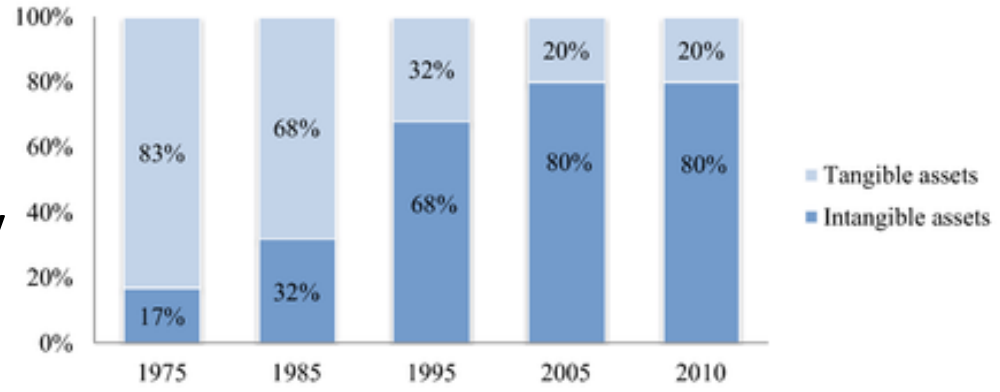
Introduction

A Question of Value - “Value must exceed the price."

- IP valuation is complex
- Complex interaction of legal and business issues as well as uncertainties
- **What is the value put on table before prospective investors?**

Introduction

Importance of valuing IP



- IP an asset / currency
- IP an asset
  - Deal leveraging / cross licence)
  - Collateral / security
  - Sold / disposed of
  - Licenced / leased
  - Basis for a joint venture
  - Competitive advantage / market leadership
  - IP new currency in knowledge based economy

Introduction

Factors Affecting Valuation

- Quality of the IP Asset
  - Depth and breath of patent claims
  - Prosecution history
  - Territories granted
  - Distinguishing ability
  - Quality of underlying product
  - Time to market
  - Inherent commercialisation risk
- Litigation / infringement

Introduction

Fundamental Questions in Valuation

How Much Is My IP Worth?

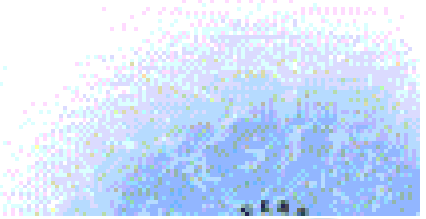
Re-Thinking IP Valuation

Short Answer:
whatever someone is prepared to pay for it

But:
organisations are increasingly expected to include patents and other IP onto their balance sheet

Why Value IP?

- Evaluating potential merger or acquisition candidates
- Identifying and prioritising assets that drive value
- Strengthening positions in technology transfer negotiations
- Making informed financial decisions on IP maintenance, commercialisation and donation
- Evaluating commercial prospects for early stage R&D
- Valuing R&D efforts and prioritising research projects
- Supporting a valuation for loan collateral



Introduction

Fundamental Questions in Valuation

What is the value added by IP Assets?

With IP

What are the cash flows from existing assets?

Without IP

When will the company become mature / sustainable, and what are the potential constraints / barriers?

- Competition
- Regulatory
- Etc.

How risky are the cash flows from both existing assets and IP assets?

IP Valuation

Different Valuation Methods

- **Cost method**
- **Market method**
- **Income**
  - 25% rule (relief from royalty)
  - Discounted Cash Flow
  - Monte Carlo simulations

IP Valuation

Valuation of Early Stage Technologies – Cost Approach

- **Cost approach most used for nascent / early stage IP**
- **Cost approach doesn't consider patent monopoly value**
  - Grossly undervalues IP in some cases
  - Other methods - Discounted cash flow, Monte-Carlo, 25% rule
- **Risks**
  - laboratory to large scale manufacturing / market adoption
  - Failure to be cost effective to manufacture
  - Stronger and newer competitive technology will emerge
  - Regulatory hurdles (e.g. undesirable side-effects in case of drugs)
  - May not achieve promised benefits

IP Valuation

Market approach

- Similar to real estate valuation
- Higher value than cost approach
- Dependent on availability of transactional information

IP Valuation

Income Approach - 25% Rule

- Value of trademarks used by a company
  - R100m turnover
  - Pays R4m in royalties
  - Generates R24m in profits (before royalties, interest and tax) (PBIT)

Profits before royalties, interest and tax:	R24m
Reasonable royalty rate (using 25% of PBIT):	R6m
Royalties:	(R4m)
Reasonable royalty	R2m
Trademark Royalty:	**2% of turnover**

http://www.snz.co.za/articles/valuation/use-of-the-25-rule/

IP Valuation

25% Rule (cont…)

- Contrast with inappropriate valuation of same trademarks:
  - R100m turnover
  - Pays R4m in royalties
  - Generates R24m in profits (before royalties, interest and tax) (PBIT)

Profits before royalties, interest and tax:	R24m
Royalties:	(R4m)
PBIT:	R20m
Reasonable royalty (using 25% of PBIT)	R5m
Trademark Royalty:	**5% of turnover**

http://www.snz.co.za/articles/valuation/use-of-the-25-rule/

Royalty Rates for Different Industries

Royalty Rates for In-Licenisng by Industry							
Industry	0-2%	2-5%	5-10%	10-15%	15-20%	20-25%	>25%
Aerospace	50.0%	50.0%					
Automotive	52.5%	45.0%	2.5%				
Chemical	16.5%	58.1%	24.3%	0.8%	0.4%		
Computer	62.5%	31.3%	6.3%				
Electronics		50.0%	25.0%	25.0%			
Energy		66.7%					
Food/Consumer		100.0%					
General Mfg.	45.0%	28.6%	12.1%	14.3%			
Governmetn/University	25.0%	25.0%	50.0%				
Health Care	3.3%	51.7%	45.0%				
Pharmaceuticals	23.6%	32.1%	29.3%	12.5%	1.1%	0.7%	0.7%
Telecommunications	40.0%	37.3%	23.6%				

Source: Dan McGavock of IPC Group, Chicago Based on survey results

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Royalty Rates for Different Industries

RoyaltySource® from Transaction Analysis

Industry		Average	Median	Max	Min	Count
Chemicals		4.7%	4.3%	25.0%	0.1%	78
Internet (incl software)	11.8%	8.8%	50.0%	0.3%	88	
Telecom (excl Media)	4.9%	4.5%	15.5%	0.4%	73	
Consumer Gds, Rtl & Leis		5.5%	5.0%	28.0%	0.1%	98
Media & Entertainment	9.1%	5.0%	50.0%	2.0%	25	
Food Processing		3.2%	2.8%	10.0%	0.3%	38
Medical/Health Products		6.1%	5.0%	77.0%	0.1%	376
Pharma & Biotech		7.0%	5.0%	50.0%	0.0%	458
Energy & Environment	5.0%	5.0%	20.0%	1.0%	107	
Machines/Tools		5.2%	4.5%	25.0%	0.5%	90
Automotive	4.3%	3.5%	15.0%	0.5%	59	
Electrical & Electronics	4.2%	4.0%	15.0%	0.5%	139	
Semiconductors		4.3%	3.0%	30.0%	0.0%	75
Computers & Office Equip		5.3%	4.0%	25.0%	0.2%	73
Software		11.5%	6.8%	70.0%	0.0%	147
Industry Summary		6.40%	4.80%			1,924

Concluding Remarks

- Be explicit about:
  - Exactly what are we evaluating
  - In what context
- Develop an Influence Diagram

Concluding Remarks

- Valuation complex and depends on a number of factors
- Important that employ appropriate valuation method
- Valuation done for variety of reasons:
  - New investments
  - Capital raising
  - Commercialisation – e.g. licensing or venture creation
  - Tax purposes
- An art more than a science
- Don’t let valuation kill the deal!

THANK YOU

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Backup Slides - IP Valuation

Tax or Structured Finance Transactions

IP Valuation

Tax or Structured Finance Transactions

- Tax or structured finance transaction - essential that IP valuation pass close scrutiny
- Not sufficient to merely adopt “common methodologies”, “rules of thumb” and “benchmarked royalty rates”
- Not genuine purchase price severely undermines the nature of a sale

> *“Now in the first place it is significant that the agreement of sale fixes the purchase price at the exact sum which Ormond owed Kaplan. It has been laid down that one of the tests as to whether a sale is genuine or not is whether there has been a true and fair price. The price is arrived at in this case without any* ***consideration as to the value*** *of the goods.”*

Gardiner JP’s comments in Anderson v Kaplan 1931 CPD 50 at p52:

IP Valuation

Tax or Structured Finance Transactions (cont....)

- In South Africa, **nearly all** IP valuations performed for tax purposes apply the discounted cash flow (DCF) model in combination with the "25% Rule" (for determining a "reasonable royalty") – Relief from Royalty Methodology.
- 25% Rule only appropriate where the IP:

> *(a) represents a strong arsenal of assets;*
> *(b) is shown to be valid and enforceable;*
> *(c) is a driver of sales or profits; and*
> *(d) grants the holder protection against competition.*
>
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IP Valuation

Tax or Structured Finance Transactions (cont....)

- 25% rule – high valuation
- Not appropriate for nascent technologies as well as copyright (software, etc) owing to ease to circumvent
- Cost method may be appropriate

> *"A note of caution: Although the relief-from-royalty method has been in use for many years, in the last decade it has become* ***misused and abused to a great extent.*** *Too many valuations are based on these theoretical "marketplace royalty rates" to calculate value ... For the most part, the cost approach might be an appropriate method to use when valuing technologies in the earliest stages of development, or when equivalent functional, non-infringing alternatives may be easily designed (****e.g. software****) because it reflects the cost a company could avoid by purchasing, rather than duplicating, a similar R&D effort."*
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