

Valuing Intellectual Property and Intangibles

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“If nature has made any one thing less susceptible than all others of exclusive property, it is the addition of the thinking power called an idea, which an individual may exclusively possess as long as he keeps it to himself; but the moment it is divulged, it forces itself into the possession of everyone and the receiver cannot dispossess himself of it.” - Thomas Jefferson

“Everything that can be counted does not necessarily count; everything that counts cannot necessarily be counted.” – Albert Einstein

What do we mean by intellectual property and intangibles? Basically intellectual property or IPR is any intangible asset that consists of human knowledge and ideas, so an intangible is something that is not tangible!

So looking further into this an intangible asset is therefore something of value that cannot be physically touched and examples might be franchises, patents, trademarks and brands. It can include goodwill from a business, it can be a database, it can even relate to knowledge as to what does not work.

Which of these is more valuable? The Coffee Bean and Tea Leaf or Starbucks coffee? Why...

Can the brand be worth more than the sum of the values of the physical property? If we look at some of the major shopping centres such as Bluewater in the UK it would appear that the brand could well be worth more than the actual buildings. This is something that needs to be taken into account by valuers in order to avoid under-valuing the worth of the asset.

Taking another example if we had a restaurant run by a famous chef it could well be that there is a waiting list of several years to get a table at the restaurant. This ought to be reflected in the value of the property for accounts purposes. Yet if we look purely at the income per year there is only a maximum amount that can be obtained for a given size of restaurant. How do we differentiate for the fact that there is a waiting list?

There is some dispute between surveyors and accountants as to the correct methodology and also as to who should be carrying out the valuations. Basically, however, accountants tend to look at past performance whereas as valuers we consider future income.

According to the website www.valuebasedmanagement.net ‘intangibles create future value. All intangibles are future oriented. Because of this they are ignored by traditional accounting systems due to the conservatism concept. Valuing intangibles is difficult because intangibles are not evidenced by financial transactions.’

I would suggest that although it is difficult in many instances to value intangibles, we do now have the methodologies to carry out such valuations and there is even evidence if one looks hard enough for other transactions.

What do we need to know before valuing intellectual property?

1. Who is the client? As we shall see, different clients will require valuations for different purposes.
2. What is the basis of valuation? Is it market value we are considering or value to the business? There could be a considerable difference between the two.
3. Why is a valuation required?
4. What is the life expectancy of the intellectual property?
5. What differentiates the product from its competition?

How do we compare brands? Why do some people prefer a Lexus to a Jaguar? How do we compare Lexus with Toyota - after all they are basically the same car with a different badge? And then, what about a Hyundai? They all can carry 4 or 5 people in luxury, are of a similar size and a reasonable performance, yet there is a considerable difference to what people will pay for them.

The same problem applies with all intellectual property; intellectual property is difficult to value but it can be done!

Why is the type of client important?

Different types of clients will use the valuation for different purposes. For example, banks would probably be looking at it as loan security, an insolvency practitioner or lawyer would be looking to return the value of the asset to creditors, it may be required for corporate purpose for accounts or to enable future investment, merger or even demerger. Finally a venture capitalist may be looking at it for security.

There are four main methods of valuation that are adopted:

1. Capitalisation of historic profits.
2. Gross profit differential method.
3. Excess profits method.
4. Relief from royalty method.

The method to be used depends upon the type of intellectual property being valued and the reasons for doing so.

1. Capitalisation of historic profits.

This is basically an accountancy method and is the method that we valuers have traditionally used for valuing goodwill of going concerns. The methodology is simple enough. We assess the average historic profit, we then multiply by a suitable YP taking into account the relative strength of the intellectual property. However, it is historic so it pays little regard to the future.

It is often argued nowadays that the goodwill element of a business should not be separated from the property value, since the goodwill could not exist without the property. Whereas we used to value land and buildings and then add a YP of up to a maximum of about 3 on the trade profits, there is an increasing trend to value the property and the goodwill together just

using a more realistic YP based on the likely return on the money tied up in the business. By this method we ignore the value of the land and buildings as they are simply a 'means to an end'.

However, if the business being considered was badly managed it can show too low a figure, conversely if it was particularly well managed business then the figure may well be too high.

2. Gross profit differential method.

For valuing brands the gross profit differential method is often used. The methodology is to look at the difference in sale prices between the margin after costs, between the branded product and an unbranded or generic product. For example if we were to look at brands of painkilling medicines, such as, Neurofen or Panadol then we could look at the difference between the sale price less costs of production of the Neurofen or Panadol and the unbranded or generic product such as Ibuprofen or Paracetamol, respectively. This difference can then be put in a cash flow run over an appropriate number of years to produce the value of the brand.

The main problem with this method is arriving at the base price for the generic product. In some cases the generic products could be sold as 'loss-leaders' to promote trade or in some cases there could still be a small element of branding to the generic product. For example, in comparing a basic UK student food staple such as baked beans, should we compare Heinz Baked Beans with Tesco 'Value' baked beans or should we compare with the even cheaper baked beans sold by supermarket chains such as Lidl or Aldi? Is there still an element of branding which increases the cost of the Tesco 'Value beans'?

3. Excess profits method

For this method we consider the current value of the net tangible assets employed and use this as a basis for calculating an estimated rate of return or profits that would be required to induce investors to invest in these net tangible assets.

For example, we could consider the value of the actual costs of a shopping centre, any return over this can then be considered to be the excess return attributable to the brand or the intellectual property of that particular shopping centre. We can then apply an appropriate year's purchase to this to arrive at a value of the brand or, more often, put it into a cashflow. This will have to take into account future costs required to maintain the brand both by means of additional marketing costs but also any costs of refurbishment, etc.

4. The relief from royalties method

For this method we consider what the purchaser could afford or would be willing to pay for a licence for the particular intellectual property. The royalty stream is then capitalised on a basis which reflects the risks and returns from such an investment. Such a method can often be used for valuing computer software or a database of client information or research data.

With all of the last three methods it is normal to apply the figures to a discounted cash flow to arrive at a capital value. There are various models used to arrive at a suitable discount rate depending upon risk. However, one of the most important factors to determine is the time span to be used; intellectual property can often have a very brief life. It is important for the valuer to appreciate this and to take it into account.

In determining useful life we must consider such matters as:

Physical Life

- E.g. the physical life of the buildings of a shopping centre before major works or redevelopment may be required.

Functional Life

- How long will the business continue to be in demand?

Technological Life

- E.g. for computer software this may be very limited

Economic Life

- For how long will it be commercially viable?

Legal Life

- Patents may expire

Determinants of time scale

- what type of IP are we considering
- what will affect its value?

Brands, Logos and Trademarks can evolve with a company. They may resurge as a brand reinvents itself or takes on a new technology. If we consider the example of Apple computers they made their name from the Apple Mac computer and were extremely successful. They then gradually lost their marketing edge and were less fashionable or profitable.

However, over recent years they have reinvented themselves, brought in new technology, new versions of their Mac computers, but more importantly the iPods which have resulted in them having 75% now of the market for MP3 type players worldwide.

Research can become out of date very quickly this obviously also has an effect on the value of the intellectual property and competitors can soon overtake the particular intellectual property being considered.

Databases can become out of date if not regularly maintained. For example, the customer loyalty cards run by many of the large food retailers such as Tesco have created an enormous database of information about customers. But unless this is regularly maintained it would soon become useless.

Software is not only sensitive to changes in customer requirements but also is sensitive to operating systems. Take for example, when the operating system DOS was replaced by Microsoft Windows new software to perform the same functions was required to run on the new operating system.

As I hope I have demonstrated, intellectual property is becoming increasingly important. It is currently a matter of much debate as to whether it should be valued by valuers or accountants.

I suggest that we as valuers should be making sure that we are actively involved in the valuation processes and hope that the four methods of valuation which I have described. They are not new and have been become established for some while. I hope that my talk may have given those of you who are not regularly involved in valuing intellectual property at the present time, food for thought as to how such valuations can be undertaken.

I have intentionally not given actual calculated examples, partly because of confidentiality, but also because each case needs to be treated on its own merits. You cannot prescribe a set YP or number of years for a cash flow to be used for any particular element of intellectual property. Taking an extreme example in some cases software might have a life expectancy of six months before it is overtaken. It has a value for that period after that it will have virtually no value. The challenge is to understand this and to value it accordingly.

I should like to leave you with a further quote from Thomas Jefferson

“Its peculiar character, too, is that no one possesses the less, because every other possesses the whole of it. He who receives an idea from me, receives instruction himself without lessening mine; as he who lights his taper at mine, receives the light without darkening me. That ideas should freely spread from one to another over the globe, for the moral and mutual instruction of man, and improvement of his condition, seems to be peculiarly and benevolently designed by nature, when she made them, like fire, expansible over all space, without lessening their density at any point and like the air we breath, move and have our physical being, incapable of confinement or exclusive appropriation.

Inventions then cannot, in nature, be a subject or property.”

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