

An AccuVal Associates, Inc./Creative IP Solutions White Paper

Capturing the Value of Intellectual Property for Leveraged Finance Considerations

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In the last few years, the identification and valuation of intangible assets, specifically intellectual property (IP) related intangible assets, has garnered increased attention worldwide for a variety of reasons that include increased compliance requirements for financial reporting but certainly also in the leveraged finance arena as lending institutions continue to look beyond traditional collateral sources such as accounts receivable, inventory, and equipment. However, where does one start with an investigation of the potential intangible asset value held within a company when the majority of all balance sheets of private companies reflect minimal, if any, intangible asset value?

INTANGIBLE ASSETS VS INTELLECTUAL PROPERTY

The potential categories of intangible assets to be considered in a financial reporting exercise *post*-acquisition include marketing (e.g., trademarks, trade/brand name, non-compete agreements), technology (e.g., patents, trade secrets, software), customer (e.g., customer relationships, distribution network), contract (e.g., leases, licensing) and artistic (e.g., print media). In defining intellectual property, which is the type of intangible asset that has not been historically considered in leveraged finance deals, it must be seen as the group of innovative technologies and/or processes which create a legally protected and marketable product or service that establishes the foundation for sustained profits and brand development. In other words, the appraiser seeks to analyze how the “product line technology” within a company has formed the basis for creating a marketable branded product.

While pronouncements by U.S. and international accounting standards boards have placed a spotlight on capturing intangible asset value, the fact remains that these assets either (a) typically remain understated on the balance sheets of public and private companies; or (b) still remain as part of “goodwill” where no clear guidance is provided in the financial statement footnotes as to the makeup of this value. However, these assets receive different consideration in other sectors. For example, the U.S. insurance industry has begun to give consideration to the fact that the infringement of intellectual property rights may trigger a legitimate “business interruption” claim.

INDUSTRIES OF FOCUS

While we have discussed the fact that any business has some level of intangible asset value, lenders will tend to focus on the intellectual property of consumer product and technology companies. This is due to the fact that these industries have a strong potential to establish long term license agreements, where the licensor is able to extract a guaranteed revenue stream through a contractually established percentage of either gross or net sales. These royalty payments are typically garnered without any consideration for the cost of goods sold and variable and fixed operating expenses of the licensee, and these payments can form the basis for one of the approaches to value in the appraisal process. In addition, the IP within these industries has a higher likelihood of being sold in the open marketplace due to brand recognition and/or the revenue streams associated with licensed technology (e.g., software). Workout officers have a growing array of potential buyers of a borrower’s IP, including current licensees, competitors and even IP investment funds, such as Intellectual Ventures or Acacia Technologies.

THE APPRAISAL PROCESS

In our recent experience, we have been requested to provide valuation conclusions for IP under the following value definitions: fair market value, orderly liquidation value, and forced liquidation value. While an active liquidation market has existed for decades for tangible asset categories, such as

inventory and equipment, the liquidation market for IP has only in recent years started to gain traction as the level of patent portfolio and brand name auctions continues to increase globally. These auctions have had mixed success, the discussion of which is beyond the scope of this article. However, it is important for the lender to realize that by far the most supportable value definition for intellectual property is that of fair market value, with consideration to the accounting definition of “fair value” which is now introducing the concept that a key consideration in a valuation should be what any independent “market participant” would pay for an asset, as opposed to the focus on the transaction price between two independent parties in a supposed “arms length” transaction.

Therefore, the appraiser must conduct a thorough investigation as the key value drivers for these assets are only understood through a detailed interview process with key company personnel, such as research and development, product development, engineering, legal and marketing. These interviews are centered on the notion that there are three categories of IP value:

- **Commercial Value** – The basis for this claim is that the company has created a product superior to that currently available in the marketplace. This value is typically given a heavy weighting in M&A valuation models. Where the IP provides a patent holder with ability to block competitors, the IP value can be measured using a market-share approach.
- **Legal Value** – The basis for this claim is centered on well-written patent claims, strong licensing agreements, and court rulings. “Courtroom” models typically include commercial and legal values under a model based on the perspective of a “hypothetical licensee” as initially defined in *Georgia Pacific v. United States Gypsum*.
- **Financial Value** – The basis for this claim is that the free cash flow generated by a company’s IP (and resulting product) solidifies its credit rating and ultimate lending collateral, such as the Bowie Bond and Bill Blass securitizations.

Understanding these value drivers leads the appraiser to the following key considerations the process:

1. What IP do you have?
2. What is the value of your IP to your company?
3. What is the value of your IP to other companies?

The key consideration for the lender should be “What is the value of your IP to other companies?” From the appraiser’s standpoint, the analysis should include consideration from a potential licensee’s perspective as to the time to commercialize an asset and an analysis as to the alternatives available to licensing. The analysis from the owner’s perspective should include a reasonable estimation of the royalty rate that these assets are most likely to obtain through a contractual agreement based upon comparable industry royalty rates, giving consideration to whether any informed “market participant” would pay a similar or possibly different rate.

CONCLUSION

While the three standard approaches to measuring value can be considered in the valuation of IP (e.g., software can typically be valued through a replacement cost new technique), a valuation for leveraged finance purposes will focus on the income approach to value (typically a discounted cash flow analysis) and market approach to value through observed transactions. The appraiser can also incorporate tech-transfer and dispute resolution models that have been used in their respective settings for decades.

The benefit to the lending community is that we live in a world more driven to identify and unlock the value of IP, both from a regulatory and from a commercialization perspective. In turn, the appraisal community has seen a significant increase in demand for IP appraisals. Lenders will gain the most comfort from working with appraisers that first and foremost understand the drivers behind asset based financing decision making. AccuVal's own history has its roots in machinery appraisals and auctions, and we understand first-hand, how adding intangibles to the borrowing base expands both the lender's profits and their due diligence efforts. AccuVal, and its partner Creative IP Solutions, believe that by accurately identifying a borrower's intangible assets and capturing all of the associated components of value, the lending community and their corporate clientele will significantly improve their respective bottom lines.

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