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As Intangible Assets Grow In Prominence, Methods To Value Them Evolve

The Editor interviews ***Daniel Roche*** *and* ***Bradford (Brad) Taylor,*** *Marcum LLP.*

Editor: Please tell us about your professional backgrounds.

Roche: I've been at Marcum close to nine years as a valuation expert, where I specialize in business valuation, including the valuation of intellectual property. I'm a manager in the advisory group, primarily in the New York City and New Jersey offices. I am a CPA and an Accredited Senior Appraiser with the American Society of Appraisers. I also hold the Accredited in Business Valuation designation from the AICPA.

Taylor: I'm a director in Advisory Services based in our New England office, and I was recently appointed National Valuation Practice Leader for the firm. I, too, am an Accredited Senior Appraiser with the American Society of Appraisers and a Certified Valuation Analyst from the National Association of Certified Valuators and Analysts (NACVA). Since 2001, I've been doing valuation work encompassing all aspects of business valuation.

Editor: What might a company's intangible assets include, and in which sectors do intangibles play the most prominent role?

Taylor: A company's intangible assets could include patents, trademarks and trade names, brand names, proprietary technology, non-compete agreements, databases, customer relationships and certain kinds of contracts. There's also in-process research and development, which may be valued as well. Intangible assets may also include goodwill.

When you think of patents and IP, you tend to think of pharma/biotech and technology first. But over the last 15 to 20 years, we've seen the recognition of intangible assets spread throughout many sectors. These days you'll also see, for example, financial institutions and lending companies with proprietary trading desks and internally developed technology.

Daniel Roche

Bradford Taylor

Intangible assets are also called "invisible assets" because they generally do not appear on your balance sheet; you do not recognize them unless you acquire them, whereas if you spend money on trade names or on patents, that expense runs through your profit-and-loss statement.

Editor: How do intangible assets derive their value?

Roche: Let's start with patents. If you have something of functional utility or a unique design, you can get a patent, which essentially awards you a monopoly to use that functional utility or design in the marketplace. If it's perceived to be a superior product, the monopoly allows you to charge a higher price or earn more profit than another entity that doesn't possess this patent. Further, if someone willfully infringes your patent, you may be awarded up to three times damages – a very significant protection. Of course, this is valid only through the life of the patent, which could be as long as 20 years.

Taylor: And, an intangible asset, especially a design or utility patent, may also enable you to lower your costs. So even though you may not be able to charge a higher price, you will still be able to increase your profit margin. You'll see that with internally developed technology or databases as well.

Roche: Exactly. Meanwhile, copyrights are granted a much longer protection period: copyrighted works and other creative ideas are protected for the lifetime of the author plus 70 years, which substantially protects the author's earning stream.

Trade names, which protect brands and images in the marketplace, can be almost indefinite in term, as long as you follow the registration procedures. The challenge with trade names is they require a lot of investment both in money and time to build in the marketplace, and they're subject to great volatility. If you receive bad news and don't handle it adroitly, your trade name may acquire a negative stigma that will diminish its value very quickly.

Editor: What are the challenges that inhere to different kinds of intangible assets?

Taylor: In the valuation of any intangible asset, you have to get down to the cash flows – the costs and the revenues – associated with that particular intangible asset. For a trademark connected to only one product, it may be simple: you need only look at the revenue from that product. In other instances, you may have a patent that is producing today, while another may be in development or awaiting FDA approval.

If you're a technology company, you may have a software product that represents 100 percent of your IP. That's easy enough. But let's say two years from now you release a new version, and just 50 percent of that new version is built upon the exist-

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ing technology. You need to start bifurcating those future revenue streams into buckets for the technologies associated with each. That's really the challenge – drilling down and understanding the revenue stream, associated costs, and the life of the intangible asset.

For patents, which last a set number of years, this may be easier to predict. Say you have a drug patent that lasts 17 years. When the patent expires and generics come onto the market, your price typically goes way down, so knowing that you're in year 12 of 17 years is extremely helpful.

Roche: Often a company will have one product and one revenue stream associated with that product. But it will also have patents, trademarks, non-competes, customer lists and a whole collection of intangible assets. Trying to value each separate bucket of intangible assets with only one revenue stream becomes very challenging. How much do you allocate to each one? And what is the interplay between all these elements? We have methods to help us unravel such complexities.

Editor: What are the most common approaches to IP valuation?

Roche: We look at three methods. The first is to determine the cost of creation, including the cost of filing of a patent, etc. The second is a market approach: you compare the IP to the cost of similar assets in the marketplace. The third, and probably the most common, is to look at the income derived from the intangible asset itself.

For newer intangible assets with no earnings to date, we would probably utilize a cost approach. However, for a company with more established trade names, patents and copyrights, we would first see if the company already has a licensing agreement in place with a third party and use the value the market perceives the intangible asset to be worth. This is somewhat uncommon, though, and little data is available.

Most commonly we use the income approach, in which we look at similar products in the marketplace with licensing or royalty agreements and apply that to the cash flows associated with that intangible asset as an avoided cost, which is essentially its value.

Taylor: When we use the cost approach, we also have to factor in any functional or economic obsolescence of the asset. As for the market approach, Dan is right. Licensing agreements do take place, but often the data is unavailable. In addition, it's not often you see a patent just like yours being sold or licensed. There are some databases with market information on licensing agreements, and when we apply this data – usually with patents, trademarks or brand names – it's called relief from royalty: i.e., your company does not have to pay somebody else a percentage of revenues because you own the asset.

There are really two methodologies for the income approach. The first is a "with and without" analysis. In the "with" scenario, your company has the intangible asset; in the "without" scenario it does not. The difference in value between the two scenarios represents the value of the asset. The second is the multi-period excess earnings methodology (MPEEM), in which you take the cash flows for one intangible asset and then take charges against those cash flows for use of the business's other assets. You're essentially drilling down to just the cash flows pertinent to that one intangible.

Editor: Are certain valuation approaches more defensible than others?

Roche: The valuation of intellectual property is evolving. Methods that were once used are not perceived to be as applicable now. There was, and is, a method to value trade names and patents called the profit split method, which was essentially a "rule of thumb." Figuring somewhere between 25 and 50 percent of profits is a good estimate of the value, and a lot of firms use this rule of thumb. I typically do not use this method. In *Uniloc USA, Inc. v. Microsoft Corp.,* a federal court essentially said that the use of this rule of thumb had no basis in market reality and more or less dismissed its use. You really have to be up-to-date with what's going on and use supportable methods. You need to look at each instance in and of itself to arrive at a defensible value.

Editor: What are some of the challenges of using intangible assets as a credit support?

Taylor: Historically, the generally held idea was that intangibles were too difficult to value. A little over a decade ago, we began to see asset-based and other lenders realizing there's value to intangible assets. The issue for lenders is, can these assets have monetization outside the company itself? Is it a safe intangible asset to be lending upon? And really, what is the value of that intangible asset? You see more lending on patents and trademarks or trade names of very well-known companies. Dan mentioned the volatility of trade names: if something goes wrong, you may encounter problems with your lenders. Not every trade name is as valuable for credit support as another; it depends on the specific facts and circumstances.

That said, as methods have evolved, it's become more commonplace for these intangibles to have some recognized value. We just recently valued a client's intangible asset for loan support.

Roche: It's riskier for a financial institution to lend based on intangible assets as opposed to tangible assets such as accounts receivable and fixed assets – because it's difficult to predict how much income can really be derived from an intangible asset in the future. Today looks great, but what about tomorrow? Generally you can expect a lending institution to charge a higher interest rate when you are borrowing on intangible assets.

Taylor: I would qualify that to say if you're *only* lending on intangible assets. If you are using intangible assets as a support of tangible assets, the inclusion of these intangible assets may actually help you lower the rate.

Editor: Is the valuation of intangibles increasingly central to business valuations overall?

Roche: As you'll typically hear in business valuation conversations, the answer is, "it depends!" If you own a company and want to know the value of your business, we'll value the cash flows and determine the value of the entity. The value of intangibles should be reflected in the overall cash flows of the business. It may not be necessary to drill any further to separate the value of the assets. Now, there are certain instances for financial reporting purposes in which you may be required to value all the separate classes of intangible assets. In certain states and certain jurisdictions, you may need to value the intangible assets as part of litigation. It depends on the purpose of your valuation and your jurisdiction.

Taylor: From a more macro perspective, think about the value of public companies, whose price per share is an expectation of future economic benefits. As we've moved away from a manufacturing economy and toward services, high-tech manufacturing and technology, there has been a shift in the amount of tangible assets versus intangible assets in an average public company's market capitalization. In the 1970s, intangible assets as a percentage of the market capitalization of the S&P companies were between 15 and 20 percent. By the mid-2000s, that percentage was closer to 80 percent. This demonstrates the market is increasingly recognizing the value of intangible assets as it relates to company valuations overall.