The Value of Intellectual Property, Intangible Assets and Goodwill†

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The paper discusses intellectual capital valuation concepts, methods and procedures adopted to apply credible value to intellectual property. Three broad categories of valuation methods, viz.: market based, cost based and based on estimates of future economic benefits are described briefly.

Intellectual capital (IPR) is recognized as the most important asset of many of the world’s largest and most powerful companies; it is the foundation for the market dominance and continuing profitability of leading corporations. It is often the key objective in mergers and acquisitions and knowledgeable companies are increasingly using licensing routes to transfer these assets to low tax jurisdictions. The questions to be answered should often be:

— What is the IPR used in the business?
— What is the value of IPR (and hence level of risk)?
— Who owns it (could I sue or could someone sue me)?
— How may it be better exploited (e.g. licensing in or out of technology)?
— At what level do I need to insure the IPR risk?

For the valuer, this is not usually a problem when these rights and liabilities take an accepted form, such as trademarks, patents or copyright, which are well enough known. This is not the case with intangibles such as know-how and proprietary technology, which can include the talents, skill and knowledge of the workforce, training systems and methods, designs and technical processes, customer lists, distribution networks, etc. Generally risk affects valuation analysis, corporate valuation must reflect risk, and most importantly risk should reflect value.

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One of the key factors affecting a company’s success or failure is the degree to which it effectively exploits intellectual capital and values risk. Management obviously need to know the value of the IPR and risks for the same reason that they need to know the underlying value of their tangible assets; because business managers need to know, or should know, the value of all assets and liabilities under their stewardship and control, to make sure that values are maintained. Exploitation can take many forms, ranging from outright sale of an asset, or a joint venture or licensing agreement. Inevitably exploitation increases the risk assessment.

**Valuation Concepts and Procedure**

Valuation is an art more than a science and is an interdisciplinary study drawing upon law, economics, finance, accounting, and investment. It is rash to attempt any valuation adopting so called industry/sector norms in ignorance of the fundamental theoretical framework of valuation.

Valuation procedure is, essentially, a bringing together of the economic concept of value and the legal concept of property. The cardinal rule of commercial valuation is that the value of something cannot be stated in the abstract; all that can be stated is the value of a thing in a particular place, at a particular time, in particular circumstances. We adhere to this and the questions ‘valuable to whom?’ and ‘important for what purpose?’ must always be asked before a valuation can be carried out. This rule is particularly significant as far as the valuation of intellectual property rights is concerned. More often than not in commercial negotiations, there will only be one or two interested parties, and the value to each of them will depend upon their circumstances. Failure to take these circumstances and those of the owner into account will result in a meaningless valuation.

There are four main value concepts, namely, owner value, market value, tax value and fair value. Owner value often determines the price in negotiated deals and is often led by a proprietor’s view of value if he were deprived of the property. The basis of market value is the assumption that if comparable property has fetched a certain price, then the subject property will realize a price something near to it. The fair value concept in essence, is the desire to be equitable to both parties. It recognizes that the transaction is not in the open market and that vendor and purchaser have been brought together in a legally binding manner. Tax valuation has been the subject of case law since the turn of the century and is an esoteric practice. There are quasi-concepts of value that impinge upon each of these main areas, namely, investment value, liquidation value, and going concern value.

**Valuation Methods**

Acceptable methods of the valuation of identifiable intangible assets and intellectual property fall into three broad categories. They are either:

— Market based
— Cost based
Based on estimates of future economic benefits.

In an ideal situation, an independent expert will always prefer to determine a market value by reference to comparable market transactions. This is difficult enough when valuing assets such as bricks and mortar because it is never possible to find a transaction that is exactly comparable. In valuing an item of intellectual property, the search for a comparable market transaction becomes almost futile. This is not only due to lack of compatibility, but also because intellectual property is generally not developed to be sold, and many sales are usually only a small part of a larger transaction and details are kept confidential. There are other impediments that limit the usefulness of this method, namely special purchasers, different negotiating skills, and the distorting effects of the peaks and troughs of economic cycles. In a nutshell, this summarizes author’s objection to such statements, as ‘this is rule of thumb in the sector’.

Cost based methodologies, e.g. the cost to create or the cost to replace, assume that there is some relationship between cost and value, and the approach has very little to commend itself other than ease of use. The method ignores changes in the time value of money and ignores maintenance.

The method of valuation flowing from an estimate of future economic benefits can be broken down to four often-overlapping limbs; capitalization of historic profits, gross profit differential methods, excess profits methods, the relief from royalty method and discounted cash flow analysis.

While the capitalization process recognizes some of the factors, which should be considered, it has major shortcomings, mostly associated with historic earning capability. The gross profit differential methods are often associated with trademark and brand valuation. The excess profits method is associated with earnings capability in order to induce investment and, while theoretically relying upon future economic benefits from the use of the asset, the method has difficulty in adjusting to alternative uses of the asset. Relief from royalty considers what the purchaser could afford, or would be willing to pay for the licence. The royalty stream is then capitalized reflecting the risk and return relationship of investing in the asset.

**Valuation Appraisal**

Discounted cash flow analysis is probably the most comprehensive of appraisal techniques. After a rigorous examination of the earnings capability of the IPR alone, potential profits and cash flows need to be assessed carefully and then restated to present value through use of a discount rate. The operating environment of the asset to determine the potential for market revenue growth should be considered. The projection of market revenues will be a critical step in the valuation. The potential will need to be assessed by reference to the enduring nature of the asset (due diligence and the
valuation process quantifies remaining useful life and decay rates). This will quantify the shortest of such as the following lives: physical, functional, technological, economic and legal, and then must subsume consideration of expenses together with an estimate of residual value or terminal value, if any.

This method recognizes market conditions, likely performance and potential, and the time value of money. It is illustrative, demonstrating the cash flow potential, ‘or not’, of the property and is highly regarded and widely accepted in the financial community. The discount rate to be applied to the cash flows can be derived from a number of different models, including common sense, build-up method, dividend growth and the Capital Asset Pricing Model utilizing a weighted average cost of capital.