Considerations in the Valuation of Royalties and Licensing Agreements

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Over the past decade, the valuation of royalty and/or licensing agreements within the context of litigation has gained significant attention within the courts, spurred in part by certain high-profile cases. In these litigation matters, the royalty agreements have been associated with the licensing of certain patented technologies. However, the various considerations and valuation methodologies also apply to trademarks, copyrights and other licensed intellectual property. To understand the property rights and the role of the royalty, it may be useful to examine the basic aspects of the licensing process.

In a license, the owner of the intellectual property (“IP”) rights transfers some of the rights to a licensee who in turn pays for those rights through the means of a royalty. This ongoing future royalty cash flow stream has value to the licensor (i.e., the grantor of the license). The purpose of this article is to focus on the valuation considerations of the royalty/licensing agreement itself rather than the establishment of the royalty rate to be paid under the licensing agreement. Our next edition of Economic Damages Update will address reasonable royalty considerations and assessment. For simplicity sake, our discussion will focus on single licenses versus bundled property rights, which are substantially more difficult to value and require the consideration of many other factors.

Considerations in the Valuation of Royalty and Licensing Agreements

There are numerous valuation considerations when addressing the valuation of a royalty or license, and depending upon the specific circumstances and purpose of the valuation, those specific considerations may vary. For most royalty/licensing agreement valuation engagements, the primary considerations will consist of the following factors:
1. The purpose of the valuation;
2. The standard of value to be applied;
3. Type of intellectual property royalty/licensing agreement being valued;
4. Reliability of the projections of future royalties;
5. Discount rate to be applied;
6. Definition of the royalty/license base for application of the royalty rate (for example gross revenues, net revenues or gross profit);
7. Length of the royalty/licensing agreement and/or remaining life of the intellectual property rights;
8. Impact of emerging technologies on impairment of existing royalty/licensing agreement; and

**Purpose of the Valuation and the Standard of Value**

The first consideration in the valuation of any royalty and/or licensing agreement is the purpose of the valuation. Common purposes for the valuation may include:

1. Buyout of the future royalty payments for cash or stock\(^1\);
2. Valuation of the future royalty/licensing agreement in a business combination;
3. Valuation of the royalty/licensing agreement for possible impairment;
4. The valuation of the royalty/licensing agreement for purposes of future sublicensing;
5. The valuation of the royalty/licensing agreement for purposes of transfer pricing; and
6. Valuation of the royalty/licensing agreement due to breach of contract.

The specific purpose of the valuation could impact several of the other valuation considerations identified above and may lead to the consideration of other factors unique to the specific circumstances and the

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\(^1\) In the case of technology companies, the developer of the technology and holder of the patent may license the technology to the company that markets the product to end users. If the company is to be acquired, the acquiring company may wish to buyout the ongoing licensing agreement to allow the company to control the patent rights going forward. This is seen commonly in publicly traded companies acquisitions of private companies where the founder(s) may control the patented technology through licensing.
specific entities involved. Additionally, the standard of value (whether fair market value or fair value) will be dictated by the purpose of the valuation.

For example, in business combinations and in the assessment of any impairment, fair value is the standard of value under generally accepted accounting principles (GAAP). In a breach of contract and/or in the assessment of future royalties for sublicensing, fair market value would be the appropriate standard of value.

**Reliability of Projections of Future Royalties**

Within the context of litigation and the admissibility factors under Daubert, the reliability of future projections of royalties and the time period that those projections cover are a critical consideration. Published business valuation literature indicates in most instances that financial projections beyond three to five years are relatively unreliable, unless related to long-term agreements where the expectations of those future income streams are more reasonably estimated. Royalty and licensing agreements with historical payment streams provide reasonable evidence of expected future royalties.

For newly established royalty and licensing agreements with no historical track record, projections can be assessed for reasonableness based on the historical track record of projecting other royalty and licensing agreements that the licensee or the licensor may have been involved. The existence of demand for the IP under license may also support the reasonable basis of the projections.

**Discount Rate**

The various considerations included in the selection of an appropriate discount rate for purposes of determining the net present value of the future royalty/licensing income stream is similar to the process encountered in a normal business valuation in that market derived returns should be considered. The build-up method to deriving a discount rate is one methodology that can be applied. The build-up method takes into consideration the specific risk factors associated with the licensee’s
business operation and the specific IP under license. Market derived discount rates based on industry and the specific cost of capital of the licensee is also an acceptable methodology.

The ultimate discount rate selected should take into consideration the relative risk associated with achieving the levels of income set forth in the royalty/licensing agreement and should consider much of the following:

1. Exclusivity of the license;
2. Acceptance and/or failure of the IP under license;
3. Ability of the licensee to support, promote and maintain the intellectual property;
4. Going concern of the licensee; and
5. Markets for which the licensee competes and nature of the intellectual property.

**Definition of the Royalty/Licensing Base for Application of the Royalty Rate**

Royalties and licensing fees are paid based on several criteria, including gross sales, net sales, gross profit and/or specifically defined income levels set forth in the royalty/licensing agreement. Additionally, the royalty rate may be applied to a bundle product or may require the allocation of value from a bundled product for purposes of determining the royalty base. An understanding of the base for which the royalty/license rate shall be applied is critical to determining the estimated amount of the future royalty income stream. The complexity of the analysis of the future income stream varies and may require an analysis of the licensee’s cost structure to determine the future projections are reasonable and based on the definitions set forth in the royalty/license agreement.

**Remaining Life of Intellectual Property Rights and/or Term of Agreement**

As previously discussed in the determination of the reliability of the future projections, the remaining life of the intellectual property and/or the remaining term of the royalty/licensing agreement itself will have an impact on the valuation of the royalty agreement. Under GAAP accounting principles, specifically identifiable intangible assets such as a license agreement are
required to be assessed for impairment under *fair value* accounting rules.

**Impact of Emerging Technologies on Impairment of the Royalty/Licensing Agreement**

The valuation of the royalty/licensing agreement may be significant affected by emerging technologies that may make the licensed technology obsolete and/or impaired. A consideration of emerging technology changes and the adoption of competing technologies by competitors is a critical consideration in the valuation of the royalty/licensing agreement and may require consultation with other outside experts familiar with technology developments. The consideration of emerging technologies may affect the life of the royalty agreement and reduce the likelihood of receiving the future royalty income stream for the duration of the agreement and/or the life of the intellectual property right. The consideration of the impact of emerging technologies can be included in the assessment of the reliability of the future projections and/or within the selection of the discount rate selected.

**Exclusivity versus Non-Exclusivity/Sublicensing**

A consideration of whether the royalty/licensing agreement provides exclusive use by a single licensee or whether the prospect exists for future sublicense is an additional consideration that may affect the value of the royalty/license agreement. If sublicensees were granted based on specific geographic areas, the various considerations identified previously would be required to be performed on a geographic basis. Additionally, if sublicensees are granted without regard to geographic region and all licensees compete in the same market, the valuation of a specific royalty/licensing agreement may require an analysis of the specific licensee’s historical market share and/or estimate of future market share for purposes of valuing the specific royalty/license agreement. As these considerations taken into account the complexity of the analysis increases.

**Final Note**

The considerations required in the valuation of royalty/licensing agreements follow many of the same considerations for a business valuation except for an added layer of complexity that the royalty/licensing agreement is a subset of a company’s overall operations and the
development of projections and the required analysis may require detailed cost structure and revenue analysis of separating total business operations for those factors specific to the royalty/license agreement being valued.

It is precisely because of this complexity that when the valuation is within the context of litigation that the many admissibility factors related to Daubert must be considered and factored into the overall analysis.

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