How to Value Intellectual Property

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Many businesses rely on some form of intellectual property (IP) to generate cash flow. And whether for infringement litigation, income tax reporting, accounting compliance, bankruptcy, divorce or strategic decision-making purposes, determining IP's value has become increasingly important.

First, it's important to understand what intellectual property is:

A subset of intangible assets that is generated by human intellectual or inspirational activity, which can consist of patents, literary and musical copyrights, trademarks, trade names, and trade secrets. In most cases, companies or individuals must register IP for federal and state legal protection.

Intellectual property doesn't appear on a company's balance sheet unless it buyers it from an outside party. IP can generate significant value either through operating or licensing income.

Determining the Value of Intellectual Property

This is done by starting with interviews and requests for relevant documents. This can include:

- Registration papers;
- Historic and projected financial statements;
- Tax returns; and
- Relevant licensing and royalty agreements.

For IP valuations to be meaningful, collaboration with a VR M&A advisor is critical. Through interviews, we are able to understand IP rights as well as underlying technology, life cycles, economic benefits, possible risk factors, highest and best use, and relevant marketplace.

Approaches to Appraising IP

After gathering preliminary information, it's time to crunch the numbers. Appraisers generally use, but may slightly modify, the three traditional valuation approaches when valuing IP:

1. Cost approach. This estimates the cost to reproduce or replace an IP asset. The analysis includes direct costs (such as labor and materials) and indirect costs (such as legal, administrative, and research and development expenses). Valuators also consider a reasonable return for the IP developer. To estimate fair market value, valuators adjust reproduction or replacement cost for functional, technological or external obsolescence.

2. Market approach. Comparable IP sales and licensing agreements can, in theory, provide objective support for IP values. But because IP often provides competitive advantage, many companies carefully guard the details of IP transactions. Unearthing comparable transactions requires in-depth review of SEC filings or access to proprietary transaction databases. Possible selection criteria include the asset's:

- Description,
- Standard Industrial Classification (SIC) or
- North American Industry Classification System (NAICS) code,
- Income-generating potential,
- Age and remaining useful life, and
- Transaction date.

Some IP transactions involve special terms or conditions that skew valuation results. For example, a licensing agreement may restrict the licensee's rights, say, to a specific geographic area. To the extent that comparable transactions limit the purchaser's or licensee's rights, the market approach underestimates the value of unrestricted IP ownership.

Conversely, using a comparable sale involving an earnout or installment payment may overestimate the value of an IP asset, unless the comparable transaction is adjusted to its cash-equivalent price.

3. Income approach. The value of IP lies in its ability to generate future cash flows for its owner. The income approach projects an asset's income over its remaining useful life and discounts the income stream to its net present value.

A major component is projected income. To estimate future income, valuators may extrapolate historic earnings trends using statistical analysis. Absent an operating history - or when future operations are expected to deviate from the past - valuators perform their own analyses or rely on management's income projections. Optimistic IP developers tend to overestimate asset potential. So, valuators generally view internal projections skeptically, especially when valuing unproven technology or when management lacks industry experience.

Another component is remaining useful life. IP assets generate income over a finite period. Determining IP's remaining useful life is a function of several factors, including age, legal protection, contractual rights, physical obsolescence, life cycle and competition.

A further component is the discount rate. In addition to matching the discount rate with the appropriate measure of economic income, discount rates should be commensurate with the risk of the IP asset. Riskier IP assets warrant higher investor returns. In turn, higher discount rates equate with lower IP values.

Hybrid Approaches

Appraisal methodology seldom fits neatly into one of the three standard valuation approaches. The relief-from-royalty method illustrates how a valuator might combine the market and income approaches to value an IP asset. This method estimates how much the company would have to pay a third party in royalties if it didn't own the subject IP.

A valuator derives a reasonable royalty rate from comparable transactions. He or she then multiplies the royalty rate by the company's projected income stream (possibly net revenues, gross margin or operating profits). Finally, projected royalty payments are discounted to their net present value over the asset's remaining useful life using a discount rate commensurate with the IP asset's risk.

Experience Counts

IP valuations differ from traditional business appraisals. To ensure accurate, meaningful appraisals, seek advice from a valuation professional who understands this complex valuation niche.

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