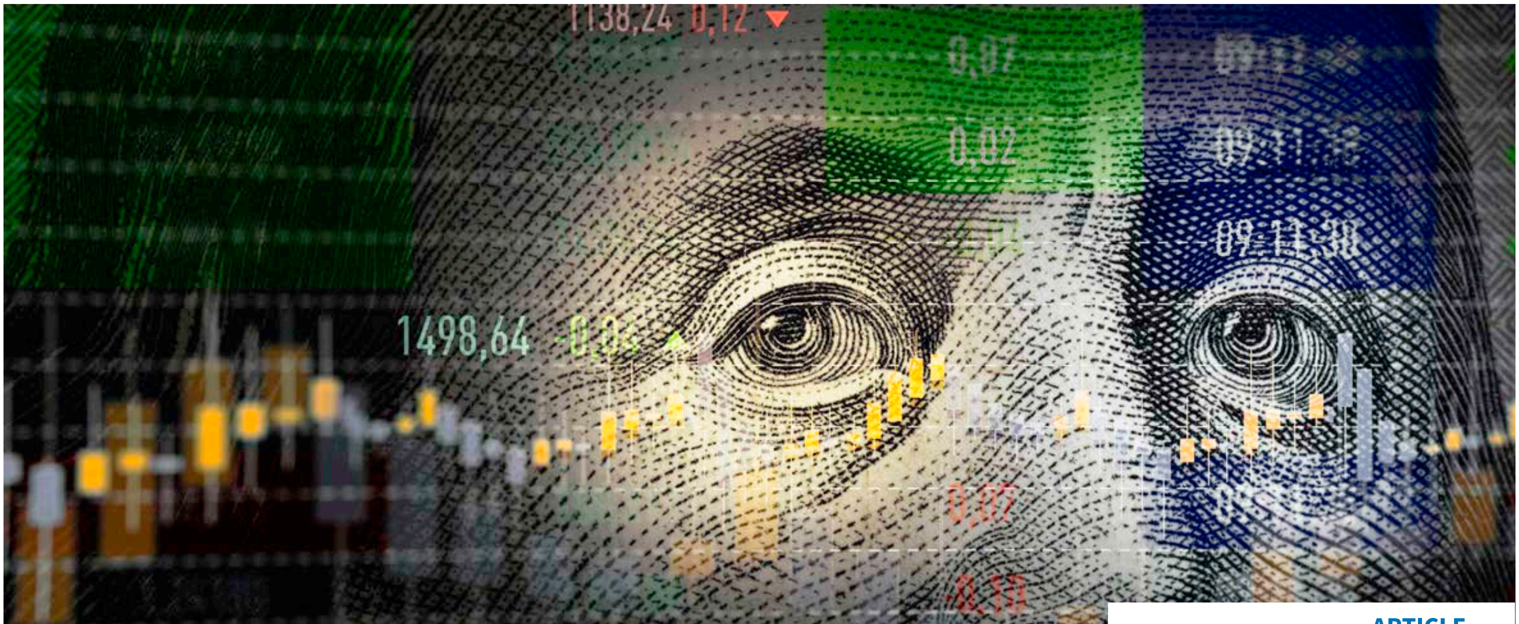

ARTICLE

3 Approaches to IP Valuation for Pandemic Recovery

The COVID-19 pandemic sent shockwaves around the globe, many of which still reverberate. Facing a public health crisis, many countries, including the U.S., enacted strict measures to slow the viral spread. While closures, shelter in place orders, and social distancing efforts may have lessened the infection count, an economic cost was extracted. As unemployment levels soared, other unintended consequences manifested including the crippling of many businesses, both large and small. Unfortunately, in some cases, these entities will shutter permanently.

As companies attempt to climb out of the COVID-19 inflicted rubble, difficult choices will be weighed. For some, these alternatives may include bankruptcy or restructuring. For others, a merger or acquisition may be on the horizon, whether welcomed or not. Other options may encompass a sale or licensing of assets for a needed cash infusion. Regardless of which path is taken, a rigorous valuation of a company's intellectual property will likely be required.

For many U.S. businesses, one of the most valuable assets on the balance sheet is intellectual property. In fact, in many cases, various forms of intellectual property and intellectual capital provide the competitive advantage necessary for success.[1]

As such, assigning a reasonable value to these differentiating assets is paramount in a restructuring, sale, or licensing situation, in order to effectively capture the intellectual property's monetary worth. Understanding the potential impact of the COVID-19 pandemic may prove beneficial, if not crucial, in determining an intellectual property asset's value.

1 As defined here, intellectual capital refers to the intangible value of a business that is not listed on the balance sheet including but not limited to human capital, relational capital, and intangible structural capital.

Initial Assessments

One of the first steps in valuing any asset, including intellectual property, is determining the standard of value. Standard of value generally reflects the purpose of the valuation. In most litigation settings, fair market value will be preferred, and a hypothetical buyer considered.

Additional standards of value include investment value and fair value, among others. Investment value may be appropriate when considering a specific party or transaction. Fair value can have several uses with different meanings commonly defined either legally or through accounting standards.

Next, the purpose of the valuation should be examined. In the above scenarios, a company may be in the throes of bankruptcy or restructuring. Alternatively, a business may be seeking transaction advisory related to a merger or acquisition or the sale or licensing of intellectual property. Often, the purpose of the valuation will dictate the level of rigor required. The premise of value should also be envisaged. An entity that will continue as a going concern is in a much different position than a company embroiled in an orderly or forced liquidation.

Finally, all valuations are a snapshot in time. Therefore, an appropriate valuation date should be selected.

Valuation Approaches

Generally, valuations occur over three phases: due diligence, analysis, and reporting. Gathering appropriate inputs during the due diligence stage is crucial. During due diligence, practitioners may seek to interview company personnel who are knowledgeable about the specific market associated with the intellectual property. Company representatives may also be able to supply an assessment of the relative strength of the asset, such as its importance to an overall portfolio. Routinely, a valuation is only as accurate as its assumptions. Typically, one of three valuation approaches are employed:

— Market approach;

— Income approach; or

— Cost approach.

CASE STUDY

VALUING IP IN A RETAILER RESTRUCTURING

SITUATION

A well-known U.S.-based retailer of specialty apparel sought to restructure its existing debt obligations. The company undertook a large-scale debt restructuring transaction that involved the transfer of certain intellectual property assets, including its domestic retail trademarks, to a group of newly formed subsidiaries. The transfer of intellectual property, among other factors, allowed the company to restructure its existing debt obligations by offering the transferred intellectual property as collateral in its new refinancing agreements. A minority group of creditors objected to the transfer of the intellectual property assets on the basis that the assets represented all or substantially all of the entity's assets – allegedly violating the terms of the retailer's term loan.

OUR IMPACT

FTI Consulting's Vince Thomas and his team, including Jack Schwager, Jacob Hutchins and Vladyslav Torishnyak, rebutted the minority group's assertion. They valued the transferred intellectual property as well as the totality of the entity's other assets on the date of the transfer. In doing so, they implemented several different approaches in valuing the relevant assets, including methods under the income and market approaches. They also combined experience in the retail industry with expertise in the valuation of intellectual property assets to appropriately value the company's trademark assets as well as the overall value of the firm's assets. Working closely with the company and attorneys, the FTI team provided support, guidance, and assistance in outlining how the value of the transferred intellectual property compared to the total value of the retailer's assets.

The market approach attempts to value the asset by observing the price of comparable assets or other relative value indicators. As such, this approach relies heavily on identifying comparable transactions. Like when purchasing a home, valuing intellectual property under the market approach requires practitioners to pinpoint transactions or valuations of comparable assets.

With identification complete, practitioners then account for similarities and differences between the subject intellectual property and the comparable transactions. Adjustments may include but are not limited to industry type, market conditions, nature of technology, time period, deal terms, and context, such as litigation or settlement.

The income approach seeks to convert anticipated future cash flows into a present value as of the valuation date. This widely used approach requires numerous inputs, including determining the nature, timing, and risk of the future cash flows associated with the intellectual property. Estimations of future prices and costs may be needed to deduce the incremental profit associated with the subject intellectual property.

The remaining useful life of the asset may also be considered. Legal, technical, and commercial risk should be assessed, typically in the form of a discount rate. Discount rates may be determined in several ways, including using benchmarks and the build-up method, with the objective being to tie the selected rate to the riskiness of the intellectual property's expected income stream.

The cost approach attempts to quantify the amount of capital needed to replace the future capability of the asset. This approach may be useful when identifying appropriate comparable transactions or constructing future business models would prove difficult. Contrary to its name, the cost approach does not consider product standard costs or other bill of material costs but instead includes those costs needed to reproduce or replace the asset. As with all approaches, adjustments will need to be considered, including potential technology obsolescence or fluctuations in market demand.

Additional Considerations

In some instances, the availability of relevant inputs will dictate the selection of the valuation approach. Practitioners should weigh the results of the valuation against the facts and circumstances associated with the purpose of the valuation. Additionally, valuation adjustments may be needed to account for control and marketability of the intellectual property assets.

Finally, the valuation opinion of an intellectual property asset is not a guarantee of value for a transaction, just as an appraisal value on a diamond does not ensure someone will pay that amount. Ultimately, a negotiated deal involving the subject intellectual property represents the absolute measure of monetary worth at a specific point in time.

Potential Impact of COVID-19

Not surprisingly, much discussion exists within the valuation community regarding how practitioners may address the economic impact of the COVID-19 pandemic, especially challenging considering the full impact is currently unknown. The growing consensus suggests that valuations with an as-of date that follows market knowledge of COVID-19 should consider the pandemic's impact on the value of the intellectual property.

Generally, difficulties in determining the appropriate impact is not justification for ignoring it completely.

Conversely, if the valuation as-of date is prior to any reasonable knowledge of COVID-19, the pandemic may be classified as a subsequent event. A subsequent event is not known or knowable as of the valuation date, and certain guidelines state that the valuation would not be updated to reflect any impact.[2]

CASE STUDY

CREATING A COMPLEX PATENT VALUATION MODEL

SITUATION

A large (4,000+) telecom-related patent portfolio had been acquired several years earlier by a consortium of interested companies, including device makers and infrastructure equipment manufacturers. A private equity firm was interested in purchasing the patent portfolio in order to monetize its market value within the telecom ecosystem through a variety of commercial activities.

OUR IMPACT

FTI Consulting's Shelly Irvine and Brian Napper led a team of professionals in providing a sophisticated income valuation model that covered a variety of monetization activities. Unlike more traditional income approaches to patent portfolio valuation, FTI constructed a model that considered multiple additional variables, including:

— Existing patent litigation case law (e.g., the Entire Market Value Rule)

— Realistic duration of licensing activities and outcomes

— Divestiture opportunities of a sub-section of the portfolio

— Standard Essential Patents (SEP) and the changing guidelines related to Fair Reasonable and Non-discriminatory (FRAND) royalty rate and behavior determinations

— Patent applications and patent issuances

— Geographic considerations

Further, the market approach was also utilized in assessing technically and economically comparable patent portfolio acquisitions, making detailed adjustments as appropriate. The cost approach was considered but not relied upon, given an inability to link research and development costs directly to the patents within the subject patent portfolio. FTI worked closely with many of the named inventors on the patents as well as experienced licensing professionals at the company in providing the patent portfolio valuation.

2 *See, e.g.*, American Institute of Certified Public Accountants ("AICPA") VS Section 100 Subsequent Event Toolkit at https://www.aicpa.org/interestareas/forensicandvaluation/resources/standards/aicpa-vs-section-100-subsequent-event-toolkit-coronavirus.html. Specifically, paragraph 43 of VS section 100 states: "Subsequent events are indicative of conditions that were not known or knowable at the valuation date, including conditions that arose subsequent to the valuation date" and "[t]he valuation would not be updated to reflect those events or conditions."

Impact of a Valuation

As evidenced, a valuation entails an untold number of assumptions and adjustments. Care should be exercised and economic rigor performed in preparing a valuation of intellectual property assets. As companies rise out from under the COVID-19 pandemic, siphoning the proper value from these intellectual property assets is critical for businesses amid the current economic uncertainty.

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