Intellectual development

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With intangible assets and intellectual property in particular assuming greater importance in the market, Nat Baldwin offers insight into making valuations that can inform corporate decision-making

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In corporate culture, there are few areas that cause as much cynicism and distrust as the valuation of intangibles and intellectual property (IP). Yet most are comfortable with the self-evident truth that IP now drives our economy, and as it receives ever-greater investment the trend towards valuing such property appears inexorable (see Figure 1).

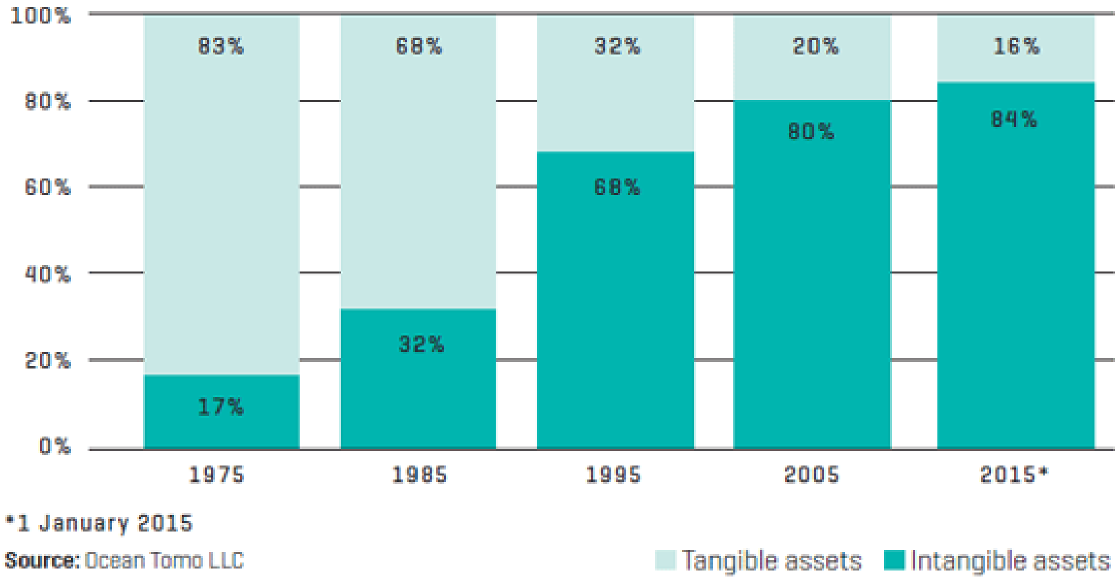

Figure 1: shows the components of the Standard & Poor's 500 market value

Intangible assets can be the most valuable in a company for myriad reasons, and everyday value is being assigned to companies whose asset strength is entirely intangible. To say that the most valuable companies in the world are so because of IP is not an exaggeration: recognisable examples include Facebook, Microsoft and Apple, with 80% of the market capitalisation of each said to be attributable to its intangible value. This is not only true for tech giants, and the value of intangible assets, including IP, pervades all companies in all sectors. It can be and often is the driving strategic force in a merger, acquisition or joint venture. Unfortunately, intangible asset disciplines have not progressed at the rate they should have, and practices have lagged behind as advisors struggle to get to grips with the class. In the current asset-based lending climate, with a trend towards finding and leveraging as many valuable assets as possible, it is perhaps surprising that these disciplines have not caught up.

A number of the world?s largest organisations, representing $20tr under management, are therefore seeking to introduce an alternative method of reporting company performance to investors that includes intangible assets such as brand value and company culture. The coalition includes more than 20 companies and investment funds, such as Nestl? , PepsiCo and Unilever .

However, a core issue to address is that current accounting standards do not allow for intangibles to be stated on a corporate entity?s balance sheet unless that entity has been acquired as part of a business combination.

Definition

Let us begin with a quick run-through of some terms that can often lead to confusion. What is intangible asset value? What is the difference between this and IP value? And what constitutes goodwill?

For the purposes of this piece, it is perhaps best to use the RICS Valuation Global Standards 2017 Red Book , VPGA 6 ? Valuation of Intangible Assets, and the definition from the International Valuation Standards 2017 IVS 210 Intangible Assets:

> 'An intangible asset is defined as a non-monetary asset that manifests itself by its economic properties. It does not have physical substance but grants rights and/or economic benefits to its owner.'

This definition offers the correct groundwork for understanding the expansive nature of intangible assets, which include rights, relationships and IP.

IP itself is an umbrella term that covers a variety of legal rights attached to various types of information, ideas and their forms of expression. This includes: patents; copyrights; trademarks; formulas; recipes; specifications; formulations; training programmes; marketing strategies; artistic techniques; customer lists; demographic studies; product test results; and business knowledge such as suppliers? lead times, cost and pricing data, trade secrets and know-how. While the above list may seem extensive, it is not exhaustive.

Goodwill can in turn be described as a premium paid over and above the fair value of assets during the purchase of a company, reflecting all the things that make a company worth more than its book value. An important distinction between intangible assets and goodwill is that the latter is attached to a company or business and cannot be sold or purchased independently. This could include the skill and expertise of the management team in a company, but also its reputation and its customers? loyalty.

Beyond the balance sheet

There are a host of reasons and contexts for having IP valued, beyond ensuring that the balance sheet stacks up. For simplicity?s sake, we can describe these as falling into 2 categories, transactional and non-transactional purposes. Transactional valuations are required for matters relating to: mergers, acquisitions and disposals; capital allocation decisions; price negotiations; IP licensing; fund-raising; and insolvency and restructuring. For non-transactional purposes, the requirement may arise as a result of: shareholder disputes; IP disputes; litigation; project evaluation; rates of return and discount rates estimation; and financial reporting, compliance and good governance.

For the former set of purposes, it can be critical to recognise intangible value as this might often be the only source of value for a company?s assets, or be critical to achieving a business goal. In 2011, for instance, UK firm TUI Travel used 2 of its brands as collateral in a deal with pension fund trustees with the aim of plugging a ?400m deficit. In a pioneering move, the company used its intangible assets as leverage, whereas previous deals of this kind had leveraged property assets ? a notable example being the deal carried out by Deloitte for Marks & Spencer. TUI had none of these, and thus resorted to its intangibles.

However, transactions of this type have been slow to take off. The UK Intellectual Property Office published a report calling for small and medium-sized enterprises, lenders and other financiers to raise their awareness and appreciation of IP beyond patents, and to put this to practical use for business innovation and growth. This was almost 5 years ago.

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Even so, its message remains as significant today as it did then. Asset-based and alternative financing methods should be targeted for IP-backed interventions; these are the parts of the financial sector best accustomed to understanding and assessing individual assets and their value, as well as putting this to use. Table 1 sets out the estimated intangible value in large-scale organisations.However it must be said that there are areas where IP value is intrinsically linked to and operates in tandem with tangibles, so work must be done with other valuation professionals to deduce an accurate overall valuation for a group of assets.

Rank	Brand	Estimated brand value* (US$m)	Book value of intangible assets (US$m)	Estimate relation of brand value to book value of intangible assets	Enterprise value (US$m)	Proportion of enterprise value represented by brand value
1		178,119	8,620	20.7x	636,745	28%
2	Google	133,252	19,775	6.7x	459,952	29%
3	Coca-Cola	73,102	21,128	3.5x	200,788	36%
4	Microsoft	72,795	21,605	3.4x	422,303	17%
5	TOYOTA	53,580	-	N/A	293,132	18%
6	IBM	52,500	40,887	1.3x	190,496	28%
7	SAMSUNG	51,808	4,664	11.1x	162,261	32%
8	amazon	50,338	4,638	10.9x	356,954	14%
9	Mercedes-Benz	43,490	3,474**	12.5x	178,232**	24%
10	GE	43,130	86,900	0.5x	423,107	10%

* Interbrand Best Global Brands 2016 (https://bit.ly/2DX6dLE) ** Financial information for Daimler AG

Table 1: shows the value of intangible assets

IP carries significant value both when businesses are healthy and when they are in distress. As I have discovered through years of personal experience in disposing of IP, there is a growing, sophisticated marketplace for assets as a discrete class. Many companies in the unfortunate position of having to liquidate assets have been pleasantly surprised by IP?s capacity to generate substantial recovery values.

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In an age before Kindles and iPads, Borders was one such business that fell prey to the emerging online economy; however, Hilco was able to generate aggregate recoveries in excess of $17m for its IP, namely its global trademarks, e-commerce site, customer database and internet protocol addresses. Despite its household appeal, RadioShack had suffered a similar fate, but once again IP assets provided more than just a trifling figure, as Hilco generated proceeds of around $40m from the sale.

Valuation techniques

Understanding the methodologies, core concepts, industries and intended use ? tax, financial reporting or so on ? requires the experience and expertise to produce a quality IP valuation analysis that is reasonable and auditable. The rule of thumb here is that which is applied in all commercial valuations: it cannot be done without proper context. Therefore the following questions must be answered before a valuation is carried out: what is the purpose, and for whom is the valuation being performed? Due to IP?s unique nature, it is also worth noting that the valuation will be relevant only to a specific place, at a specific time and in specific circumstances. Largely, though, a market approach, income approach or cost approach is followed.

Market approach

The market approach measures the value of an asset by comparing recent sales or offerings of similar or substitute property and related market data. The 2 primary market approach methods are the similar transactions method and the market multiple method.

The unique nature of IP means that, even if sales values for comparable IP are available, adjustments are required for differences in the asset?s utility and for factors such as the relative market conditions at the time of the sale and the asset?s remaining economic life. However, once intangibles are more thoroughly considered and attributed a value, particularly in distressed scenarios, this approach is likely to become more reliable. Developing IP valuation practices means recognising the importance of market intelligence, and Hilco makes use of the data obtained from its worldwide asset disposition and acquisition activities to this end.

Income approach

The income approach uses a discounted cash flow methodology such as net present value to value an intangible asset based on income and expense data. This approach measures the present value of expected future returns from the intangible asset. There are many income approach methods, though the International Valuation Standards 2017 draw our attention to the following: excess earnings method; relief-from-royalty method; premium profit method or with-and-without method; greenfield method; and distributor method.

Given that royalty data relative to IP transaction is more widely available, the most frequently used method is relief from royalty. This considers what the purchaser could afford, or would be willing to pay, for a licence of similar IP rights. The royalty stream is then capitalised reflecting the risk and return relationship of investing in the asset.

Cost approach

The cost approach uses the cost information to value an intangible asset. The 2 major costs used in practice include the following: development cost ? that is, the cost to create ? and replacement cost ? that is, the cost to re-create. This assumes that there is a direct correlation between cost and value; in reality, the approach is not as reliable given the frequently non-linear relationship between the development cost of certain IP and its value.

This is reflected in a situation where millions of dollars are incurred on unsuccessful research and development of technology that has negligible value, or little is spent on technology that proves to have significant value. However, the approach can have its uses in specific circumstances, particularly in relation to discrete assets such as a website that has just been created by a third-party contractor at a known cost.

Conclusion

Intangible resources are now the most valuable elements in an organisation, although they can also entail the greatest risks if they are not well managed. Companies are increasingly appreciating the value of their intangible assets. Over the past 12 years, when the Standard & Poor?s 500?s value increased 102%, brands in the global top 100 with the strongest brand equity increased 172.1%.

With stakeholders better appreciating intangible assets? value, their valuation is an area of huge potential growth and demand. It is expected that, in the coming years, techniques will become further homogenised and IP valuations will take centre stage alongside more traditional forms such as real property and business valuations.

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Further information

- Related competencies include Valuation , Valuation of businesses and intangible assets
- This feature was taken from the RICS Property journal (October/November 2018)
- Related categories: Business valuation and intangible assets