

Hidden Gold - Valuing and managing your IP

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Much has been written about intellectual property (IP) - or knowledge that can be applied to developing a new product, service or process. In fact, it is an entire area of the law, with textbooks devoted to its protection, trade, and valuation. Yet although large business may have lawyers and teams devoted to governance, contracts, and compliance, many will have no resources dedicated to intellectual property.

Ponder that for a moment.

It is really quite astonishing, because for many businesses, intellectual property is their only asset. It reflects quite poorly on so many Australian company boards, that extensive time and resources can be spent managing risk, but so little on managing IP, the seeds of innovation.

IP can be valuable, as it is tradable and can be protected. IP can be documented and publicly recognised as a patent, covering for instance a set of designs for a product, or a description of the process for rolling steel. However, often IP may not be recognised as such, even to those inside the organisation that developed it – for example, trade secrets such as how to project manage an event such as the Commonwealth Games. IP might even include the information in a customer database, or knowledge about markets and competitors, although it should be said that there is some debate whether such implicit data is better described as ‘intellectual capital’.

The distinguishing characteristics of IP are that it

- is an intangible asset,
- can be owned, and
- has associated usage rights.

Therefore, it may have value.

Thus a DVD of a movie is a physical asset – not IP. However, the data that constitutes the video and audio are indeed IP, and it is owned by the studio that produced it. By purchasing a retail DVD, the customer is licensed the right to view the IP – presumably in the privacy of their own home – but not to reproduce the movie on other DVDs, or to show it to a paying public. The IP ownership and rights on the DVD are protected, by copyright legislation in this instance, or patents in the case of designs for products or processes, or trademarks in the case of signs and logos. Trade secrets are not legislated rights, but are obtained by the organisation in simply keeping the related knowledge confidential. The DVD without the IP is practically worthless.

Most texts on IP will point to patents, trademarks, and copyright as examples of IP, but frequently the real hidden gold is the IP that is none of these. It is the internal and frequently implicit knowledge that is both difficult and expensive to reproduce. It can be used to create a real barrier to entry to other competitors.

Since it is an asset, IP should be managed. As with most things being managed, it is usually best to have a management strategy in place. An organisational IP strategy needs senior management support and leadership, because it must be recognised as a key business process (frequently part of the broader knowledge management process). IP strategy also demands an IP policy that details how IP is identified, registered, protected, and dealt with inside the organisation. IP policy touches many functions and tasks in an organisation – such as recruitment of staff (since new staff must be aware of their rights and responsibilities regarding IP), weekly team meetings (since new IP should be disclosed), contracts (since ownership of IP developed or exchanged must be considered), and business development (since the organisation’s IP must be recognised and protected within the supply chain).

Since IP is a tradable asset, it is essential to ensure that its ownership is well defined, for one cannot sell or licence what one does not own. The person paying to develop the IP may not necessarily own the IP, particularly when there is prior IP, or background IP, contributed by the developer. IP in an architect’s plans for a commissioned building will belong to the architect, unless the ownership is specifically transferred in the contract between the architect and client. However, the default position for an employee is that the employer owns any IP created during the course of normal employment duties. Ownership can become even more convoluted if there are multiple parties or organisations contributing background IP and collaborating. Because IP rights can be assigned, ownership of any new IP can be negotiated between the developing stakeholders separately from the right to use it, although it is inevitable that issues of novelty and valuation will arise during the course of such negotiations.

Valuation of IP for early stage ventures continues to remain one of the most difficult and subjective tasks for early stage businesses developing new products. Because of the long time frames associated with getting a technology product to market, most of the value in IP is associated with the future benefits that will flow from the IP or venture.

In many cases the customer may be another company in a long value chain, and the relationship with final consumers of the product is generally limited. Therefore the feasibility analysis and the business plan have to consider an intermediate customer. The value of the intellectual property is related to the level of that customer’s interest, the business’ exit strategy and when the intent to divest is likely to occur in the life cycle of the venture.

Generally, there are three broad approaches commonly used for valuation: the cost-based approach, the market approach, and the future income/revenue approach. Different methodologies will produce different valuation results and some methodologies will be more appropriate than others depending on the particular situation. Ultimately of course, the true value of IP is determined by the particular price someone is willing to pay.

Using the cost-based approach, the value of the IP or associated technology is assumed to be equivalent to the historical cost of development and protection, with some added return. Sunk patent costs may no longer be relevant, and instead a modified replacement cost, based on what it would cost now to redevelop the technology or IP; knowing what has been learnt, should be used. This value is usually lower than the original cost. Such an approach is most often used for legal and accounting standards requirements, or when comparable market information is not available. It is also useful during litigation when damages from IP infringements need to be determined.

The market approach looks at industry standards in comparable markets. It measures the present value of future benefits by obtaining consensus from other similar transactions between unrelated parties that have occurred in the marketplace. This is the most common approach used in licensing, since it reflects a fair market value for the technology or IP.

A number of sources are available to identify comparable transactions, such as databases, surveys, outcomes from litigation, or disclosures contained in securities industry filings. A related approach is to auction the IP to discover the market price of an asset. An auction discloses information on the IP or technology to a broad number of potential customers and accepts different sealed bids. This approach is useful when a number of interested buyers exist or when up-front payments are being targeted. This approach assumes that the highest bid will reflect the true market value. The disadvantage with this method is that the willing seller has less control in setting the price as this is left to competitive market forces.

The final approach estimates value from the present worth of the estimated net economic benefits (cash receipts less cash outlays) to be received over the life of the property. The discounted cash flow is the most accepted method in the financial marketplace since the majority of financiers are comfortable and familiar with the time-value of money. This methodology can be applied at any stage of development of the technology, limited only by the ability to accurately estimate the future cash flow. This approach also requires significant knowledge of the competitive environment.

An even quicker check on valuation can be achieved by using a royalty of 25% of the expected gross profit, before taxes, from the enterprise operations in which the intellectual property is used. This method, the so-called “25% rule”, is a rough rule of thumb, but is useful to generate a ballpark valuation. It is also useful when the intellectual property is at a commercial stage or for litigation purposes. It should always be used with caution since it does not consider a fair return on investment nor potential profitability.

To get started and learn more, a powerful and practical resource is the AIC’s White Paper “Realistic Valuations of Intellectual Property” in the research library at www.ausicom.com. Take a peek, you might find you’re sitting on some hidden gold.

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