



Navigating Uncertainty:

Patent Values and the Evolving IP Market





Sessions

- Tuesday, May 26th – Valuation Framework
- Thursday, June 25th – Patent Values in Business Transactions
- Thursday, July 30th – Patent Values in Litigation



NAVIGATING UNCERTAINTY: PATENT VALUES AND THE EVOLVING IP MARKET

Valuation of IP in a Business Transaction

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Agenda

- Why does a business have value?
- Why does IP have value?
- Intersection of IP value and business value
- IP Transactions
- Frequently asked questions
- Summary



Definition: Fair Market Value

Fair Market Value

“The amount at which a property would change hands between a willing seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts.”

- American Society of Appraisers, *Business Valuation Standards*



Why Does a Business Have Value?

- Future benefits of ownership (i.e. measure of economic income, such as cash flow, earnings, or dividends)
- Creates/delivers products or services to customers
- “There is no theoretical support, conceptual reasoning or empirical data to suggest that the value of a business...would equal the company's book value.”

- Shannon Pratt, *Valuing Small Businesses & Professional Practices*

Why Does a Business Have Value?

	Year 1	Year 2	Year 3	Residual Year
Revenue	\$ 5,000	\$ 10,000	\$ 15,000	
Expense	(3,000)	(7,000)	(11,000)	
Depreciation/Amortization	(500)	(750)	(900)	
EBIT	1,500	2,250	3,100	
Taxes @ 40%	(600)	(900)	(1,240)	
Net Income	\$ 900	\$ 1,350	\$ 1,860	
Plus: Depreciation/Amortization	500	750	900	
Less: Capital Expenditure	(400)	(675)	(900)	
Less: Changes in Working Capital	(150)	(275)	(250)	
Undiscounted Free Cash Flow	\$ 850	\$ 1,150	\$ 1,610	\$ 1,650
Present Value Factor @ 10%	0.953	0.867	0.788	
Discounted Free Cash Flow	\$ 810	\$ 997	\$ 1,269	
Present Value of Cash Flows	\$ 3,076			
Residual Year Cash Flow	\$ 1,650			
Capitalization Rate: Discount Rate Less Long-Term Growth	7.50%			
Present Value Factor @ 10%	0.788			
Present Value of Residual Year Cash Flow	17,338			
Equals: Indicated Value of the Business	\$ 20,414			

**Note: This example is hypothetical and should not be relied on for any other purpose.*



Why Does IP Have Value?

- Allows a business to incrementally enhance profitability and cash flow today and possibly in the future (i.e. Price premiums, cost savings, and expanded market share)
- Allows owner to exclude others from the marketplace
- Development time and research costs can create barriers to entry
- Potentially has a positive contributory effect on the value of the assemblage of assets

- Russell L. Parr, *Intellectual Property Infringement Damages*



Why Does IP Have Value?

- From a commercial banker's perspective, intellectual property has value as an asset if it meets two criteria:
 - it can be identified and located if necessary
 - it would be missed if it no longer existed

Why Does IP Have Value?

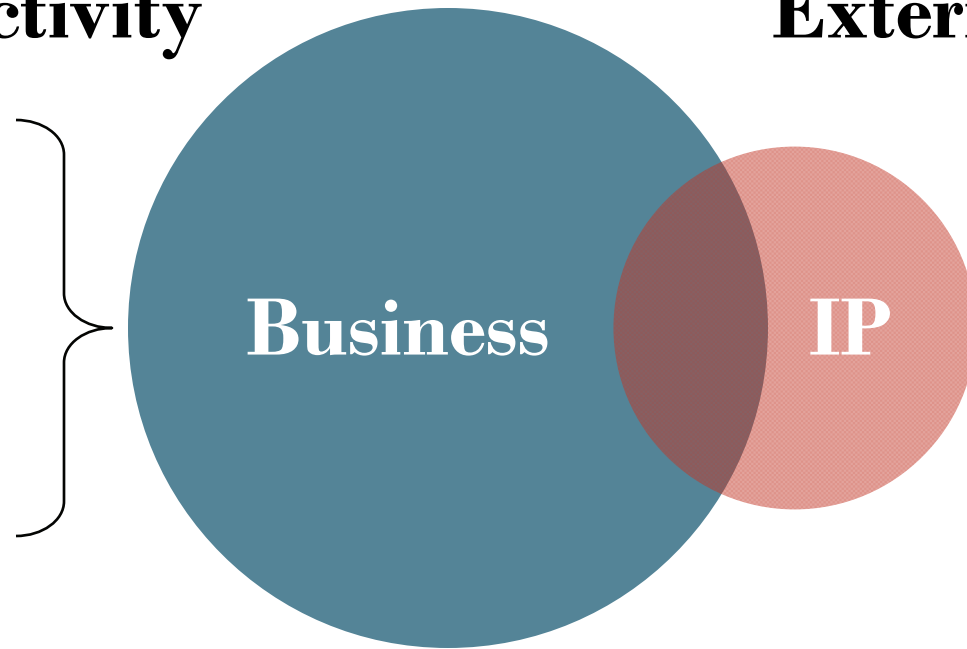
	Year 1	Year 2	Year 3
Earnings Before Interest and Taxes ("EBIT")	\$ 1,500	\$ 2,250	\$ 3,100
Intellectual Property Estimated at 25% of EBIT	25%	25%	25%
Income Attributable to Intellectual Property	\$ 375	\$ 563	\$ 775
Taxes @ 40%	(150)	(225)	(310)
After-Tax Income Related to Intellectual Property	\$ 225	\$ 338	\$ 465
Present Value Factor @ 10%	0.953	0.867	0.788
Discounted Free Cash Flow	\$ 215	\$ 293	\$ 366
Present Value of Intellectual Property Cash Flow	\$ 873		
Tax Rate	40.0%	40.0%	40.0%
Amortization Factor (15 Years)	6.67%	6.67%	6.67%
Present Value Factor @ 10%	0.953	0.867	0.788
Annual Tax Savings Percentage	0.025	0.023	0.021
Total Percentage of Tax Amortization Benefit	0.070		
Fair Value before Tax Amortization Benefit	\$ 873		
Divided by (1 - Total Percentage of Tax Amortization Benefit)	0.930		
Equals: Fair Value of Intellectual Property	\$ 939		

**Note: This example is hypothetical and should not be relied on for any other purpose.*

Intersection of IP Value and Business Value

Internal activity

Innovation
License
(Relief from
Royalty, Tax
Strategy)
Royalty Audit



External activity

License
Sell
Enforce

(Licensing is the most significant activity)

■ = Realized IP Value ■ = Unrealized IP Value



Realization of Value Through a Transaction

- Sale of the Company
- Sale of the IP Asset (assignment) or an Interest (royalty stream)
- Enforce Rights in the IP Asset
- License the IP Asset



So You Think You Have An Established Value For Your IP Assets?

- Valuation Techniques
 - Comparables
 - Replacement Value
 - Capitalization of the Income Stream
 - Other Techniques
- Valuation May Be Subject To A Difference Of Opinion In Negotiations Because
 - IP Requires Further Development
 - Market For Products Unproven
 - Difference of View as to Cost of Development and/or Commercialization
- Differences Over Value Drive Transactions With Contingent Economics



Typical Structure of Consideration

- **Sale of the Company**
 - Received at Closing; Economic Expectancy Met
 - Possible Earn-Out
- **Sale of the IP Asset**
 - Received at Closing; Economic Expectancy Met
 - Possible Earn-Out
- **License of the IP Asset**
 - Receipt of Partial Consideration at Closing
 - Development and/or Commercialization Milestone Payments
 - Royalties



The Financial Dilemma of the Licensor

- Receipt by the Licensor of its Economic Expectancy is Subject to the Risk of Every Development and Commercialization Decision of the Licensee
 - Scope/ Quantity/ Timing of Financial and Human Resources to be Applied
 - Tactical and Strategic Development and Commercialization Decisions
 - Risk of Implementation



How Do You Hedge Your Bets and Increase the Chance of Receiving Your Economic Expectancy?

- **Pay Attention To:**
 - **Timing and Substance of Events Triggering Deferred Payments**
 - **Proportion of Total Consideration Received at Closing**
 - **Structure of the License Grant**
 - **Diligence Obligations of the Licensee**
 - **Governance Structure**
 - **Basis and Mechanism for the Return of Rights**
 - **What Comes Back in the Event of Abandonment or Termination**



Structure of the Grant

- **Protect Against Potential Failure of Development or Commercialization**
- **Don't Convey Away More Rights Than Are Reasonable or Necessary**
 - It's Much Harder to Get Back What You Have Conveyed Away Than it is to
 - Exploit Rights You Retained and Never Granted
- **Consider:**
 - Granting Rights Iteratively Keyed to Commitments of the Licensee
 - Granting Non-Exclusive Rights vs. Exclusive Rights
 - Imposing Field Limitations
 - Imposing Territorial Limitations
 - Term of the License Grant



Alternative Grant Model

- **If the Licensed Product / Technology Requires Development,**
 - **Consider:**
 - **Grant a Research and Development License, Plus an**
 - **Option to Acquire an Exclusive Commercialization License**
 - **Triggering Event:**
 - » **Reaching a Development Milestone**
 - » **Specified Spending**
 - **Result:**
 - **Full License Doesn't Issue Without Significant Commitment or Performance by the Licensee**



Establish an Appropriate Governance Structure

- **Joint Oversight Committees**
 - Membership
 - Authority/Jurisdiction
 - Formation/Implementation of Plans
 - Not Contractual Matters
- **Dispute Resolution**
 - Meet and Confer
 - Escalate to Senior Executives
 - Casting Vote
- **Non-Committee Dispute Resolution**
 - Arbitration



Basis and Mechanism for Return of Rights/ Products

- Breach of the Agreement
- Decision by Licensee Not to Proceed/Abandonment
- Failure of Diligence
- Under a License / Option Mechanism, License Terminates; No Need for Return of Granted Rights if Termination Occurs Prior to Fulsome Grant
- Consider the Return of:
 - Development Data
 - Product Approvals / Registrations
 - Improvements
 - Trademarks
 - Manufacturing, Marketing, and Sales Information



Frequently Asked Questions

What types of IP may have value?



What Types of IP May Have Value?

Marketing-related assets

	Sale/License	Financing	Financial Reporting (SFAS 141/142)
Trade names, trademarks	X	X	X
Service marks, collective marks	X	X	X
Trade dress	X		X



What Types of IP May Have Value?

Technology-based assets

	Sale/License	Financing	Financial Reporting (SFAS 141/142)
Patented technology	X	X	X
Trade secrets	X		X



Frequently Asked Questions

Can IP have value if not
currently used in a business?



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Value generated from unused intellectual assets:

1. Sell

2. License

3. Enforce

* A strong management strategy employs all these approaches to ensure that shareholders earn maximum returns on every dollar invested in patents and technology.



Can IP have value if not currently used in a business?

- Microsoft was ordered to pay \$521 million to the University of California and Eolas Technology for using patented technology in its Internet Explorer.
- Microsoft settled lawsuit for \$26 million with Immersion Corp. to license technology that brought a more realistic touch to the Xbox video-game system.
- eBay was ordered to pay \$29.5 million in damages to MercExchange for patent infringement.
- Research In Motion Ltd., the maker of BlackBerry, settled a long-running patent dispute with NTP Inc. for \$612.5 million.



Frequently Asked Questions

If a business securitizes the value of IP rights, will its value increase?



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Depends

Securitizing IP: Obtaining value today from a collateralized loan or bond offering in exchange for future royalty revenue and/or IP rights.

- Some differences between IP-backed bonds and other bonds
 - Lower interest rates than typical bank loans
 - Longer maturities (between 10 and 15 years)



If a business securitizes the value of IP rights, will its value increase?

IP Securitizations

In the News:

- DreamWorks - Securitization of film library rights for \$1 Billion;
- Guess?, Inc. - Securitization of trademark for \$75 Million; and
- Yale University - Securitization of royalty interest in an AIDS Drug for \$100 Million.
- BCBG Max Azria Group - Securitization of trademarks and royalties for \$53 Million

Industry	Issuance (\$MM)	Number of Transactions
Film	\$ 1,865	3
Music	446	14
Fast Food	290	1
Sports	315	1
Apparel	999	3
Pharma	100	1
TOTAL	\$4,015	23

Sources: VALUE Incorporated, VALUE Advisory and Asset Securitization Report



Frequently Asked Questions

Should all IP value go on the balance sheet?



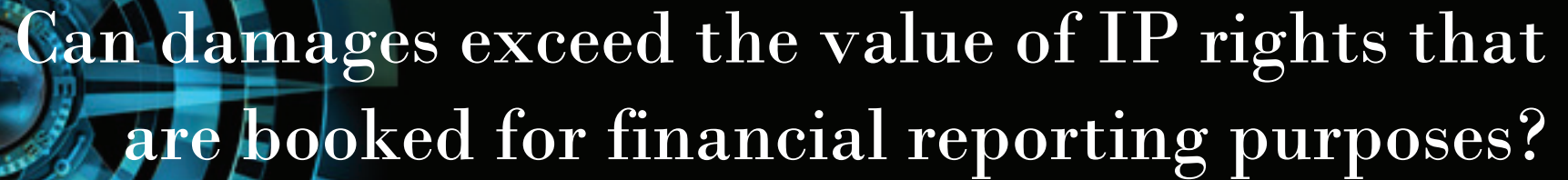
Should All IP Value Go On the Balance Sheet?

- Typically, not if the IP is developed internally by the company. (Based on current accounting standards)
- In a transaction such as a merger or acquisition and reported in financial statements in compliance with Statement of Financial Accounting Standards 141R.



Frequently Asked Questions

Can damages exceed the value of IP rights that are booked for financial reporting purposes?



Can damages exceed the value of IP rights that are booked for financial reporting purposes?

Depends

- May consider reasons why IP rights were booked and methods used in determining fair value.
- May observe implied royalty rates resulting from purchase price allocation analysis relative to damages analysis.

Example: Microsoft settles lawsuit for \$26 million with Immersion Corp. yet the company has approximately \$6,500,000 of intangible asset value on its balance sheet.



Frequently Asked Questions

Should the price of a company's stock reflect all the value of its IP rights?



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Efficient Market Hypothesis

• **‘Weak’ Form:** All past market prices and data are fully reflected in security prices.

– Technical analysis is useless

• **‘Semi-strong’ Form:** All publicly available information is fully reflected in security prices.

– Fundamental analysis is useless

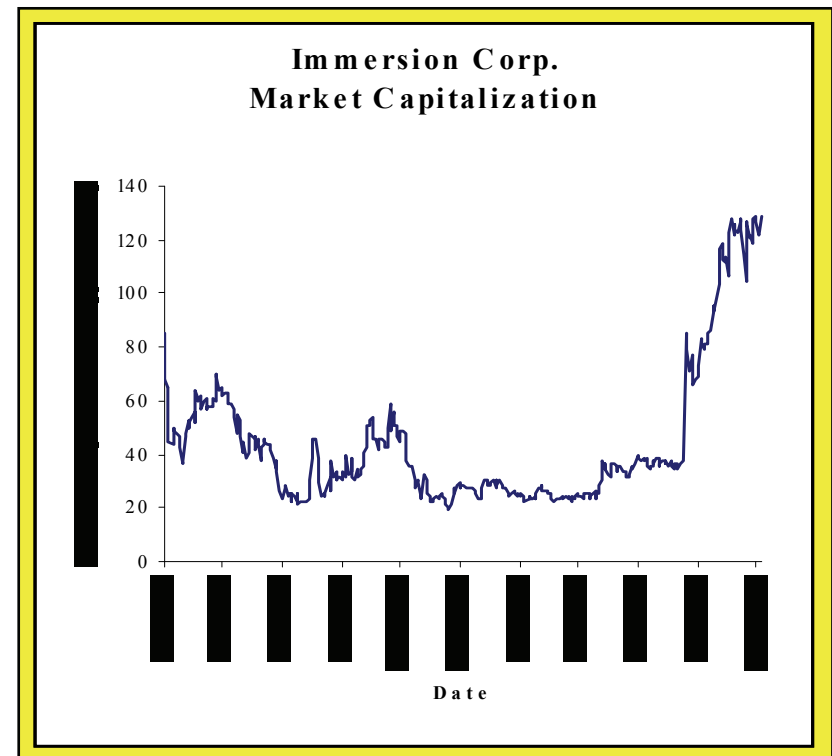
• **‘Strong’ Form:** All information is fully reflected in securities prices.

– Insider information is useless

Should the price of a company's stock reflect all the value of its IP rights?

Depends

- Is the Market efficient?
- Is the company closely followed by analysts?
- Is the company public or private?
- Other considerations

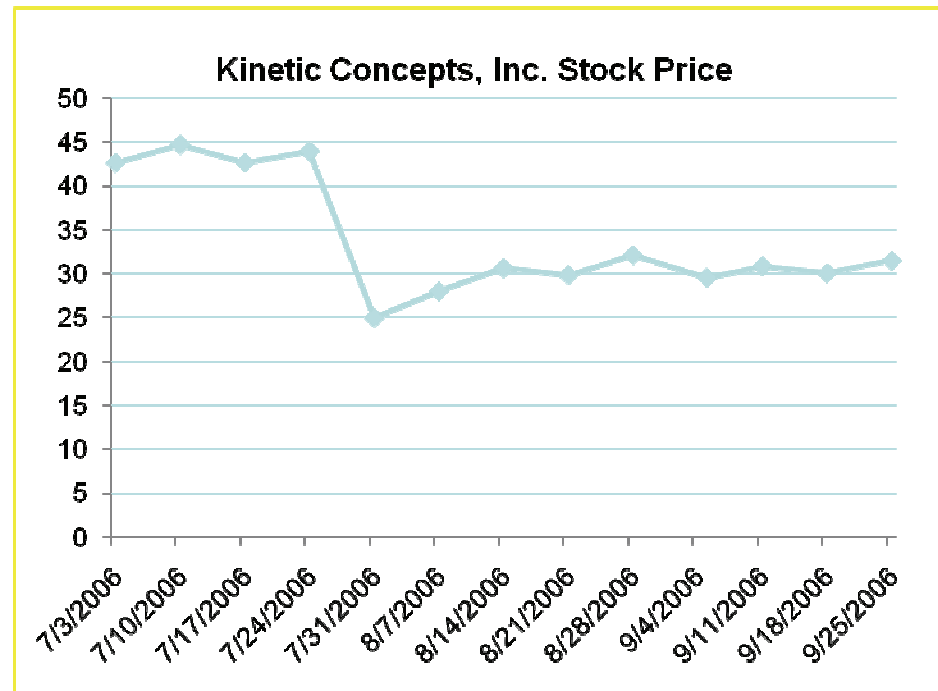


(Immersion Corp.'s market capitalization tripled based upon litigation against Microsoft)

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(Kinetic Concepts, Inc. stock price drops because patents are perceived to not be as valuable due to the legitimate presence of a second player, Blue Sky Medical.)



Frequently Asked Questions

Is it reasonable for IP damages to be greater than the value of the business?



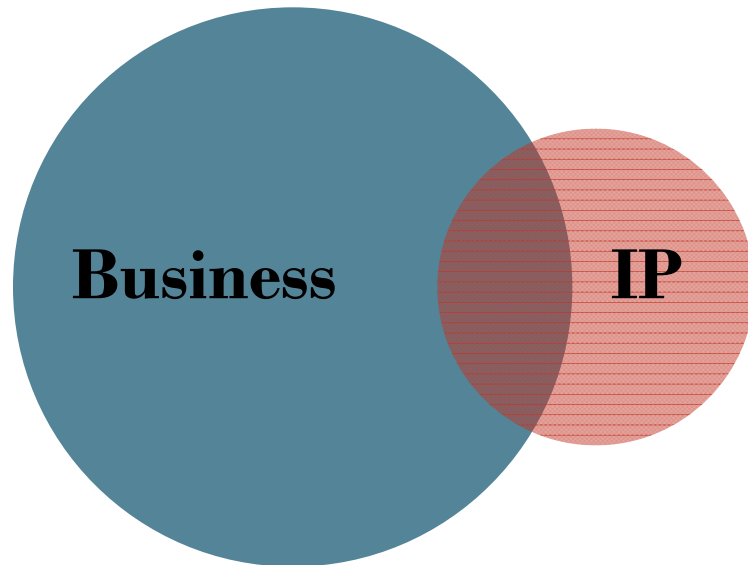
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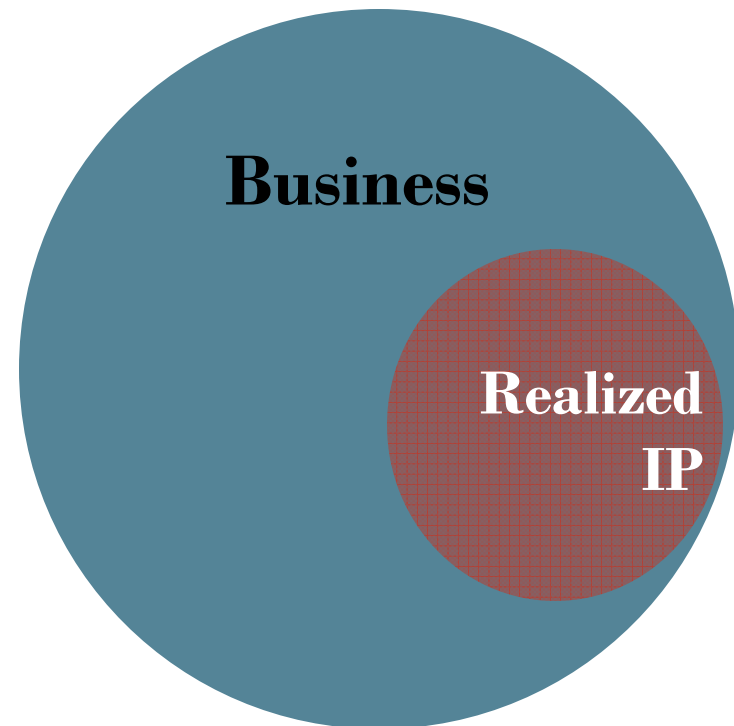
- **Date of Measurement**
- **Measure of Damages – Lost Profits or Reasonable Royalties?**
- **Plaintiff – Unrealized IP Value?**
- **Other Considerations**

Intersection of IP Value and Business Value

Unrealized IP Value



Realized IP Value



-  = Realized IP Value
-  = Unrealized IP Value



Frequently Asked Questions

How does patent life affect value?



How Does Patent Life Affect Value?

- Duration and value are positively correlated
- Economic or technological obsolescence can reduce duration
- The patent's life is bound by expiration



Summary

1. Review, examine and understand why IP is used in the business and ways it may be used outside the business.
2. Consider ways in which IP rights substantiate the quality of forecast revenue and earnings.
3. Allow for optionality related to IP rights to be considered in business value when appropriate.