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Getting a Handle on the Value of Tech Intellectual Property

By **Brian Marler,** Technology/Media/Telecom Group, Houlihan Lokey

Media and entertainment companies naturally prize the intellectual property that is their stock in trade—content such as programming, movies, and recordings. These companies also tend to appreciate and carefully safeguard the intellectual property (IP) they develop for operations, sales and marketing, including contracts, customer lists, proprietary technology and order backlogs.

Yet some of these same companies may place too little emphasis on knowing the value of technical tools developed to store, catalogue, manage and deliver their content products. Tech managers sometimes lose sight of the fact that these tools are intellectual property in and of themselves, with value that shouldn't be overlooked. After all, this IP is costly to develop, maintain and upgrade. Programmers and other staffers work thousands of hours to develop platforms and write code to assure the delivery of IP products that may hold more obvious value.

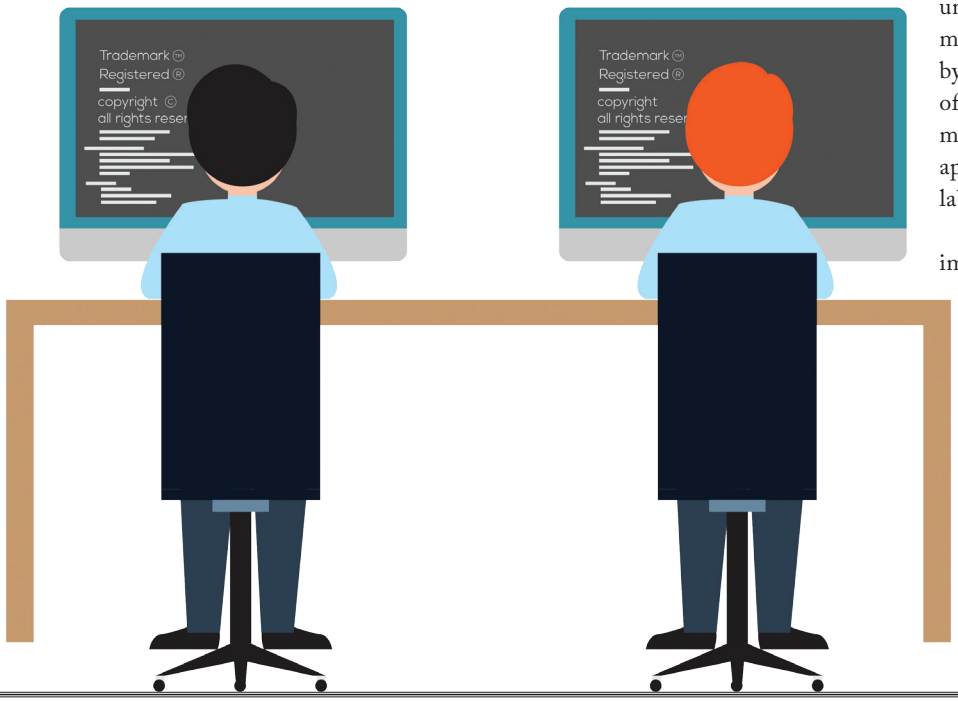
It's important for tech managers to take stock in the tech IP they develop or are looking to acquire for these purposes so they can better understand how it might be valued, along with other forms of IP, as a component of their companies' total assets. These valuations may affect views of likely financial outcomes in prospective corporate transactions (mergers and acquisitions), licensing, tax and financial reporting, and infringement disputes. They can help paint a complete picture of how your department's efforts add to the total value of your company.

Valuations are a complex undertaking best handled by highly trained professionals with specialized financial backgrounds, and IP can be one the most difficult types of intangible assets to value. Companies undergoing acquisitions or asset sales bring in such specialists, usually from investment banks, valuation firms or accounting firms, as a key step to establish value.

Valuations and the methodologies used to conduct them aren't an undertaking for laymen. However, tech managers can benefit their companies by gaining a basic understanding of pertinent elements of valuation methodologies and how they might apply to the fruits of their departments' labors.

Even when companies realize the importance of conducting valuations of this IP, they need to be proactive with their legal and financial due diligence processes. Precise, regular and comprehensive valuation of tech IP often involves assessing the impact of various key factors, including:

• Projected revenue and cash flow. The more revenue and cash flow that stems from the IP being valued, directly or indirectly, the greater the

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potential valuation. This revenue and cash flow link is frequently over or under-estimated.

• Useful life. If IP has become functionally obsolete because better alternatives are widely available, its value diminishes. In today's fast-paced tech development environment, this is a common problem. Tech IP can't be valued in a vacuum, so it's important to stay abreast of the competitive landscape to glean insights into factors affecting value.

• Migration rate. This is the rate of change for the IP under scrutiny—a factor that's commonly misestimated. Migration rates have an effect on useful life.

• Maintenance costs. The investment necessary to maintain the IP naturally detracts from value. Critical to assessing these costs is identifying or projecting the cost of upgrading existing IP from one version to the next.

• Hurdle rate or discount date, two yardsticks used to assess whether a project is worth investing in. The hurdle rate is the minimum rate of return that would be required to justify investment. The discount rate is the rate of return that would be required by a company's capital providers to compensate them for the time value of their money (money available now is worth more than the same amount in the future because of required rates of return) and the risk inherent in the particular investment.

• Patents. This includes not only the values of the patents owned or licensed by your company, but the risks from not owning a patent.

To equip valuation advisors to produce precise valuations, CFOs, CIOs and CTOs should be prepared to provide essential information. To gather this data, they should conduct an inventory of their tech IP and then take key steps, including:

The more revenue and cash flow that stems from the IP being valued, directly or indirectly, the greater the potential valuation

• Writing descriptions of all major technologies related to current products (either individually or as part of another product).

• Assembling a comprehensive history of all tech-related IP, including its connection with products, changes from previous versions and dates of development completion.

• Considering how much it would cost to recreate your IP—developer hours and rates, overhead, administration expenses, other costs and developer's profit.

• Making a list of pending or granted trademark registrations, and initiating a written assessment of their degree of recognition and economic importance.

• Creating a roadmap showing the rate of change for all IP identified, putting defensible numbers on projected revenue for each owned IP (if possible) and estimating the remaining useful life for each technology (i.e., the point in time where the next version is nearly 100 percent different from the current one).

• Breaking down R&D expenses between new product development and maintenance activities (for example, a 75 percent -25 percent split).

Valuation experts assess intangible assets using different methods such as the income approach: It is based on estimating the net economic benefit to be received over the life of the asset and includes the multi-period excess earning method and the relief from royalty method, among others. Another way is through the cost approach, which considers the cost of replacing or reproducing the asset and should take into account the developer's profit and opportunity costs, and obsolescence. Another method is the market approach, which estimates value based on an analysis of what comparable enterprises have paid for similar assets or royalty rates paid for licensing IP.

In many industries, including media and entertainment, IP may be one of the most valuable asset companies possess. Indeed, it's the lifeblood of this industry, so precise valuations are absolutely critical.

Valuation methods are constantly evolving, with ever more specific methodologies, in response to a rapidly changing marketplace and shifts in content distribution channels. Professional judgment in applying these methodologies has never been more critical, yet valuation experts must also rely on the enterprise's managers to assess factors related to all of their IP, whether it's the content to be distributed or the technology that assures its delivery. ME