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How to value IP licences
One Legal LLC

Putting a value on IP during licensing negotiations can be a complicated business. **Regina Quek** of **One Legal LLC** outlines some useful approaches and explains the issues that licensees and licensors need to take into account

How to value IP licences

Intellectual property has become the primary resource for wealth creation in many industries. There has been a paradigm shift away from traditional resources (plants, raw materials and the like) towards IP as the foundation of commercial wealth and power.

New products and services are being created based not on traditional resources but on IP. There have also been great changes – driven by technological developments – that have altered the way corporations traditionally do business. Increasingly, companies find themselves in need of technology and IP to stay ahead of the competition. However, they may not always possess the IP and technology that they need.

This in turn drives acquisitions of such technology and IP, whether by outright purchase or licensing. For this article, we will concentrate only on the licensing aspects.

IP assets

Nowadays, the definition of “capital” also includes so-called soft assets such as IP and intangible assets.

Generally IP rights are those created by law, such as patents, trade marks, copyrights and designs. Intangible assets refer to valuable intangibles such as customer lists, distribution networks and know how.

These soft assets, together with the fixed assets and working capital, all contribute to the revenue and profitability of the company.

Working capital, intangibles and fixed assets are arguably assets that all companies possess and exploit. In order to add significant enhancement to revenues and profitability, companies require the “X factor” and oftentimes, this is found in the IP.

The IP may contribute significantly to increased earnings by offering the company price premiums that it can command from the sale of the product incorporating the IP. One example of this is premium brands in the luxury goods trade.

IP may also offer cost savings that are attributable to technology-enhanced production processes. These can enhance the bottom line by offering more efficient use of natural resources, lower labour costs through automation, and enhanced product quality.

IP that is protected under law can also create barriers to entry to the market for competitors. This provides the owner with the opportunity to create and expand a market and access the higher profit margins that come with a bigger market share.

IP rights are akin to other barriers to entry, such as the need to obtain regulatory approvals from authorities such as the Food and Drug Administration. Similarly, properly protected IP is a barrier to entry to competitive products, enabling the IP proprietor to enjoy reduced competition, higher pricing options and market dominance for the duration of the IP protection.

The desirability of IP as an enhancement of a company’s bottom line is the driving force behind the acquisition of IP, whether by way of an outright sale or by licence.

In an outright sale, all rights to the IP are transferred from the seller to the buyer. The seller could receive a single payment on transfer, or a series of payments, possibly related to the success of the new owner’s exploitation or contingent upon certain events.

Licences may include franchises or joint ventures, where the owner retains ownership of the IP but assigns certain rights to another party for a specific duration and receives compensation in return.

Whatever the transaction, negotiating price is always an important part of the transaction and is dependent on the valuation of the IP.

Regina Quek



Regina Quek is a director of One Legal LLC. She has practised in the area of IP for more than 15 years. She headed the IP department in the firm she was previously with for more than 13 years until her departure in March 2005 to establish One Legal LLC. Her IP practice has grown steadily and is consistently ranked as one of the top IP practices in Singapore.

She is widely recognized for her extensive experience in protecting and enforcing IP rights in Singapore and internationally.

Regina handles all pre- and post-trade mark and patent registration matters, oppositions and revocations in Singapore as well as in different jurisdictions worldwide.

She also has extensive experience in corporate IP matters, such as licensing and the sale and transfer of IP assets. Regina is a registered patent agent in Singapore. She is also the recipient of the Bernard Fisher Scholarship 1997 for best student performance in the south east Asian drafting course.

Regina has been a speaker at and chaired numerous IP roundtable discussions and conferences including the Optimal Conference 2003 (Singapore), MARQUES Annual Conference (Rome) and the AIPPI ExCo Meeting (Geneva). She also contributes to publications such as *World Trade Mark Law Report* and *World Trade Mark Law Review*.

Regina is serving her third term as president of the AIPPI, Singapore, which she was instrumental in establishing. She is also a member of the Association of Singapore Patent Agents, the Asian Patent Attorneys Association (APAA), INTA and MARQUES.

Regina is featured in the *International Who’s Who of Trade Mark Lawyers* and is one of only four nominees in Singapore cited in the *International Who’s Who of Patent Lawyers*. She is also recommended by Euromoney Legal Media Group’s *Expert Guides* as a leading trade mark and patent lawyer and is listed in *Asia Law’s Leading Lawyers 2003-2006*.

Valuing IP

Valuation of the future worth of the IP is not an exact science and, like property valuation, may vary from valuer to valuer. The three main methods for valuing IP are the market approach, the income approach and the cost approach.

Market approach

This approach basically determines the value of a subject IP by considering the prices paid for similar IP. This is a rather crude method since it does not consider profitability, the wider economic context, exclusivity of rights granted, barriers to entry or other factors that may have an impact on profitability.

In order to work well, it would also require an active market, availability of a pool of comparable past transactions, pricing information and other relevant information.

The key is comparability. While there are numerous IP transactions, the data required for accurate comparison may not be available.

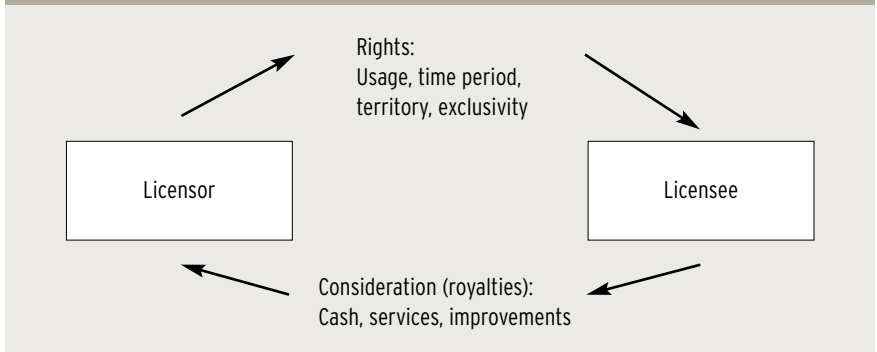
For example, the licensor may have been willing to accept a lower royalty rate if the licensee makes other concessions. The comparability would be inaccurate unless this is also factored in and duly priced.

The inherent uniqueness of IP makes this methodology difficult, particularly for emerging/embryonic technology.

Income approach

In this approach, the licensor would calculate the entire life cycle profit of the IP and factor in the costs the licensor

The essential elements of a licence



incurred acquiring the IP and the licensee's investment to exploit or develop the technology.

To do this, it is necessary to have data relating to the market and potential market, pricing possibilities and potential competition. Relevant considerations include:

- The economic climate generally, and as it affects the specific industry where the IP is to be employed.
- The economic benefits to the company attributable to the IP, whether directly (for example, premium pricing of the product) or indirectly (for example, cost savings in the production process).
- Competition, since this will affect pricing options and profitability.
- Barriers to entry, since these can enhance the value of the IP. Examples include the existence of registered IP rights, whether substantial capital investment is required and requirements to obtain regulatory approvals.
- The possibility that new technologies could emerge, making the IP obsolescent.

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	designs	enforcement	copyrights

The economic benefits that can be derived from the IP are then divided between the licensor and licensee in proportion to their investments and costs.

Cost approach

This method seeks to measure the future benefits of IP ownership by quantifying the cost of replacing the future service capability of that IP. It typically starts by considering the cost of obtaining an unused replica of that property and will look at historical costs or the re-creation cost of development of the technology and associated IP rights.

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The limitation of this approach is that certain relevant factors are not considered. These include the economic benefits associated with the IP and their expected duration, market trends relevant to that IP, the risk associated with receiving the economic benefit and the possibility of obsolescence caused by new technology.

Negotiating licences

Whatever the transaction, negotiating a reasonable price is crucial. The above methodologies assist IP owners in assessing the value of their IP with a view to arriving at an appropriate price tag for its licence.

There is, of course, no absolute method for determining price in an IP transaction and the considerations relevant to valuing the IP can often be applied to licences as well. There are a number of factors both parties should take into account.

First, the price of an IP transaction may not necessarily equate to the value of the IP involved. The price may also reflect the IP owner's exploitation strategy. For example, the pricing strategy would be affected by whether the IP is for broad application so as to set an industry standard, or for more exclusive use. In this context of licensing, value is the worth of the business opportunity. The various factors set out above are relevant to its calculation. On the other hand, pricing is the communicated offer in that business deal.

Secondly, using the bargaining tactics of vendors in street markets works poorly in licensing negotiations. The pool of potential buyers may not be very large and it may be prudent not to risk losing buyer interest by quoting unreasonably high figures. In addition, technology licensing requires due diligence from buyers. Buyers may be disinclined to even embark on and commit resources for conducting the due diligence if they have reason to believe that the IP is not value for money.

Thirdly, trust is an important factor in licensing transactions. Buyers may be reluctant to enter into a licence relationship if they feel that there is "overselling" by the seller.

A good approach would be for the seller to value an opportunity under varying levels of optimism in a scenario analysis. For example, they can consider a worst case scenario, the best case scenario and the most likely scenario.

It is also important to note that buyers may also affect the negotiation process by pricing. A low-ball offer by a buyer may offend inventors who very often have a high regard for their own technology.

Reasonable price

One rule of thumb is the 25% rule, which calculates royalty at 25% to 33.3% of the licensee's gross profits before taxes, earned through use of the licensed technology.

This rule of thumb must be viewed with caution, particularly when applied to something as complex as IP licensing. Most people would view the 25% to 33.3% figure as a good starting point but it is also necessary to factor in other considerations.

It is important to recognize that the financial benefits resulting from exploiting the IP should be shared between licensee and licensor. It is also necessary to consider the elements of risk borne by the parties and what constitutes a fair rate of return on investment.

It is critical at all times to understand the elements of a licensing transaction and particularly the elements of the transaction that affect the value of the

IP transaction.

Each element of the licence affects the transfer of rights and the future economic benefits of the parties and impacts directly on the determination of the royalties to be paid.

The elements of the licence that will affect its value are those that affect the amount of potential income, the risk and cost of obtaining the potential income and the duration of the potential income.

The amount of potential income includes royalties or other consideration, grant backs in technology enhancements by the licensee to licensor (which may yield future benefits and enhanced IP value), sub-licence provisions (with licensor participation) and whether the licence is exclusive or non-exclusive would affect the sources of income.

The risks of collecting potential income include the ability of the licensee to complete IP development (such as that for embryonic technology) or maintain support of established IP. In addition, whether the licensee grants an exclusive licence or grants rights to large territories or fields of use may increase the risk to the licensor. The parties should also consider the risk of political or economic instability during their negotiations as well as the potential exposure by the licensor to liability in the event of non-performance of the licensed technology.

The costs of obtaining the potential income include the costs of:

- administering the licence;
- quality control and monitoring of performance standards;
- technical assistance to the licensee; and
- indemnifying the licensee against infringement claims.

The factors that affect the duration of potential income include:

- the term of the licence agreement;
- the risks associated with the possibility of premature termination of the licence and licence income; and
- the economic life of the underlying technology of the IP licensed.

This is a thumbnail sketch of IP as an asset, outlying some possibilities for valuing and exploiting it to its full potential. IP is clearly an intrinsic and important part of the assets of a company and can contribute greatly to its revenues and profitability. It is important to value IP properly and decide on the best means of exploiting that value in order for it to be realized as a significant and material asset of a company.