VALUING INTANGIBLE ASSETS

AN INTRODUCTION

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INTRODUCTION

In this document I provide an overview of intangible assets and their valuation. In doing so, I have endeavoured to answer a number of common questions that I am asked, specifically:

1. What are intangible assets?

2. What categories can intangible assets belong to?

3. What is goodwill?

4. Why may you need to value an intangible asset?

5. What methods are commonly used to value intangible assets and how are they applied?

I trust that this document will assist with providing answers to some of these common questions.

WHAT ARE INTANGIBLE ASSETS?

Intangible assets are assets without physical substance that provide rights or economic benefits to their owners.

Intangible assets can be created, bought and sold. Further, they can be definite (like a brand name, which will remain with a company for as long as it wishes to hold it) or indefinite (like a customer contract which is likely to have a fixed term).

There are many examples of intangible assets, including goodwill, brands, patents, trademarks, software, customer relationships, and internet domain names.

WHAT CATEGORIES CAN INTANGIBLE ASSETS BELONG TO?

Market participants and professionals typically categorise intangible assets (save for goodwill) into one (or more) of these five (5) categories:

1. **Marketing-related** intangible assets are used primarily in the marketing or promotion of products or services. Examples of marketing-related intangible assets include trademarks, trade names, unique trade designs and internet domain names;

2. **Customer-related** intangible assets include customer lists, backlog, customer contracts, and contractual and non-contractual customer relationships;

3. **Artistic-related** intangible assets arise from the right to benefits from artistic works such as plays, books, films and music, and from non-contractual copyright protection;

4. **Contract-related** intangible assets represent the value of rights that arise from contractual agreements. Examples include licensing and royalty agreements, service or supply contracts, lease agreements, permits, broadcast rights, servicing contracts, employment contracts and non-competition agreements and natural resource rights, and;

5. **Technology-based** intangible assets arise from contractual and non-contractual rights to use patented technology, un-patented technology, databases, formulae, designs, software, processes or recipes.

In addition to these five (5) categories, **goodwill** is a further form of intangible asset which I discuss below.

WHAT IS GOODWILL?

Generally, **goodwill** is any future economic benefit arising from an interest in a business or from the use of a group of assets which has not seperately been recognised as another asset.

The value of goodwill is typically measured as the residual amount remaining after the values of all identifiable tangible, intangible and monetary assets, adjusted for actual or potential liabilities, have been deducted from the value of a business. In practical terms, this is often represented as the excess of the price paid in a real or hypothetical acquisition of a company (or a business) over the value of the company's (or business') other identified assets and liabilities.

For some circumstances, goodwill may need to be further divided into transferable goodwill (which can be transferred to third parties) and non-transferable (or "personal") goodwill.

The aspects of goodwill will vary pending the purpose (of a valuation) or circumstances (of a transaction), however goodwill typically includes these elements:

1. Company specific synergies arising from a combination of two or more businesses;

2. Opportunities to expand the business into new and different markets;

3. The benefit of an assembled workforce (but generally not any intellectual property developed by that workforce);

4. The benefit to be derived from future assets, such as new customers and future technologies, and;

5. The assemblage of a set of assets and going concern nature of a business.

Although goodwill on a stand-alone basis sometimes needs to be valued, goodwill is most often valued in conjunction with a business. Hence, for the purposes of this document, an overview of goodwill is important to assist with defining this asset in separation from other types of intangible assets, however I will not provide an overview of goodwill valuation methods nor their application.

WHY MAY YOU NEED TO VALUE AN INTANGIBLE ASSET?

There are a number of reasons that may mean a valuation of intangible assets is required, including but not limited to:

1. For **financial reporting**, particularly as part of business combinations, impairment analysis and business acquisitions.

2. For **tax reporting and compliance** particularly when such assets are transacted between related parties.

3. For **litigation**, including shareholder disputes, estate litigation and family law matters.

4. For **lending** requirements when such assets are used as collateral.

Consistent with *all* valuations, valuations of intangible assets must be prepared in a manner constent with the purpose at hand.

WHAT METHODS ARE COMMONLY USED TO VALUE INTANGIBLE ASSETS AND HOW ARE THEY APPLIED?

There are multiple methods that can be applied to the valuation of intangible assets. Herein, I provide an overview of some common methods and outline how such methods should be applied.

EXCESS EARNINGS METHOD

The **Excess Earnings Method** is classified as an income valuation approach by the International Valuation Standards, meaning that the method involves converting future cash flows to a current single value.

This method applies a value to intangible assets after excluding the proportion of cash flows attributable to other assets which are required to generate those cash flows. For example, if an intangible asset is one component of a broader business, this method would require that the cash flows only directly derived by virtue of the business holding the subject intangible asset be identified and used as the basis for conducting a valuation calculation.

The Excess Earnings Method can be applied with reference to several periods of forecasted cash flows or a single period of forecasted cash flows, with the latter more common owing to the significant difficulties that can arise in accurately forecasting business and intangible asset related cash flows into the future.

The Excess Earnings Method has multiple steps in its application, which are summarised as follows:

1. Forecasting future cash flows and expenses to be derived from the subject intangible asset and other assets which contribute to the generation of cash flows;

2. Identify what assets assist the intangible assets to derive cash flows (often referred to as the contributory assets);

3. Determine the appropriate rate of return on each contributory asset based on an assessment of the risk associated with that asset;

4. In each forecast period, deduct the required returns on contributory assets from the forecast profit to arrive at the excess earnings attributable to only the subject intangible asset, and;

5. Determine the appropriate discount rate for the subject intangible asset and calculate the present value or capitalise the excess earnings.

RELIEF FROM ROYALTY METHOD

The **Relief From Royalty Method** a particularly common method, whereby the value of an intangible asset is determined with reference to the value of the hypothetical royalty payments that would be saved by owning the subject asset instead of licensing the subject asset.

The Relief From Royalty Method is widely used and has often been accepted by courts and regulatory bodies.

The main steps in applying the Relief From Royalty Method are:

1. Develop projections associated with the income stream generated by the subject intangible asset over the life of that asset. In doing so, the most common metric projected is revenue, as most royalties are paid as a percentage of revenue;

2. Develop a royalty rate for the subject intangible asset. Two methods can be used to derive a hypothetical royalty rate. The first is based on market royalty rates for comparable or similar transactions. A prerequisite for this method is the existence of comparable intangible assets that are licensed at arm's length on a regular basis. The second method is based on a split of profits that would hypothetically be paid in an arm's length transaction by a willing licensee to a willing licensor for the rights to use the subject intangible asset;

3. Apply the selected royalty rate to the projections to calculate the royalty payments avoided by owning the intangible asset;

4. Estimate any additional expenses for which a licensee of the subject asset would be responsible, and;

5. Determine the appropriate discount rate for the subject intangible asset and calculate the present value or capitalise the savings associated with ownership of the intangible asset.

MARKET APPROACH

Under the **Market Approach**, the value of an intangible asset is determined by reference to market activity (for example, transactions involving identical or similar assets).

Typically, the Market Approach is applied by using the **Guideline Transations Method**. In doing so, valuers typically follow these steps:

1. Identify units of comparison used by participants in the market (for example, particular intangible assets may transact for a price equal to a multiple of the revenue that they generate or could hypothetically generate, with such multiple being a unit of comparison);

2. Identify relevant market transaction information, calculate valuation metrics (in other words, the units of comparison applicable), analyse those transactions (including an identification of qualitative and quantitative similarities and differences between the subject intangible asset and those for which market information exists);

3. Make adjustments to the valuation metrics in existence from your market information to account for any material differences between the subject intangible asset and those assets that comprise your market information, and;

4. Apply the valuation metrics to your subject intangible asset to calculate value.

FIND OUT MORE

For more information, or to discuss the contents of this document in further detail, please contact me at your convenience.

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