

Perspectives in Valuing Intangible Assets

by Andy Harington

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When a valuator is asked to value something, the first question they ask in return is the purpose of which the valuation is to be used. The reason is that there are various definitions of value that are applicable both to the valuation of tangible and non-tangible assets. For example, the International Valuation Standards defines six bases of value: market value, market rent; equitable value; investment value/worth, synergistic value, and liquidation value, as well as a discussion of the highest and best use concept.

For purposes of this section, I'm going to classify these definitions into two groups:

- Those that contemplate a continuation of current use - investment value, specifically investment value in the hands of the current owner.
- Those that contemplate a sale or a change in use - market value (often referred to as fair market value), market rent, equitable value, synergistic value, or liquidation value, including the highest and best use concepts.

Reflecting these two groups, there are two key perspectives in valuing non-tangible assets:

- The value in use perspective - this assumes the existing business will continue to operate in the ordinary course (i.e., as a going concern) and will continue to comprise the asset under consideration in conjunction with all other complementary assets. This is generally the perspective of management and analysts and, for ease of reference, I will refer to these parties collectively as "management"; and
- The break-up perspective - In contrast to the value in use perspective, the break-up perspective assumes that the business will be broken up such that the value of the asset under consideration needs to be considered without the benefit of any other complementary asset. For ease of reference, as discussed later, I will refer to parties that adopt the break-up perspective collectively as "regulators"⁷³.

Each of these perspectives will be discussed in more detail below.

The value in use perspective

As previously stated, those with the value in use perspective assume that the existing business will continue to operate in the ordinary course. The value of a going concern business is a function of all the tangible and intangible assets that, individually and in combination, contribute to the aggregate value. The objective of management is to maximize that value, and the resulting financial return to shareholders, both in the form of distributions to shareholders by way of dividends, and increase in the value of the underlying shares.

This maximization of value can occur in one or both of two ways:

- Increase the cash flows generated by the business; and/or
- Keep the cash flows constant but reduce the uncertainty (and the resulting discount rate) of those future cash flows. The less uncertain future cash flows are, the lower the appropriate discount rate needs to be when valuing those cash flows. For example, interest and principle distributions from government bonds are highly predictable and therefore reflect a low discount rate. By contrast, early-stage companies with high uncertainty as to the predictability of cash flows will demand a higher discount rate, even if the expected average annual cash flows are the same as for the government bonds.

Management use all tools at their disposal to both maximize cash flows and reduce the uncertainty of those cash flows. Depending on the business, intangible assets are a key tool in achieving this objective.

72. Note that investment value will differ by company. Only when a transaction is contemplated, however, is investment value to any party other than the current owner a relevant factor.

73. Note that this reference is an intentional over-simplification. When the facts support it, management may decide that the business is worth more broken up than continuing in its current form. In this case management's perspective would change from a value in use perspective to a break-up perspective.

In understanding how management uses intangible assets, it is important to remember that, for the most part, management develop intangible assets with the intention of using them in the business. Specifically, while intangible (and tangible) assets may be sold, this is only intended to occur when those assets are no longer considered necessary for the provision of the core business⁷⁴.

Rather, management anticipates that all tangible and intangible assets will continue to work together and complement the value of the other tangible and intangible assets. In fact, the investment value of each asset specifically presumes the existence of all the other tangible and intangible assets of the corporation.

For example, assume the company produces a product that both embodies a patent and is also sold under its own unique trade-mark. Management would not expect to separate the product from the trade-mark or the patent, other than, of course, the fact that patents have a finite life. Accordingly, in the hands of the company, the product, the product trade-mark, and the patented features will remain synonymous with one another, and each will contribute value to the other such that the whole will be worth more than the sum of the values of each component.

Accordingly, if this connection is broken, then the significant value may be lost. Specifically:

If the patent were sold without a license back to the seller, the product would need to be either discontinued or change so as to not embody the features of the patent. This would have a significant effect on the trade-mark value which is no longer associated with that patented feature; or

If the trade-mark was sold, customers may be easily identify the product with the patented feature, and sales would decline, thereby reducing the value of the patent.

In the event of a sale, to fully realize the values of the trade-mark and the patent, they would have to be sold together, as a package, rather than separately.

Similarly, if the brand represents a combination of assets that are intended to create “distinctive images and associations in the minds of stakeholders⁷⁵,” then it will be necessary for the trade-mark to be included in conjunction with the product features, product quality, and any service or other aspects of the customer experience that would be associated with that product “in the minds of the stakeholders.”

It is this intention to preserve and continue to operate the portfolio of tangible and intangible assets that differentiates the value in use perspective from the break-up perspective.

Accordingly, the value of any individual intangible asset in the context of value in use contemplates that the intangible assets, and tangible assets, of the business, are available to contribute to the value of the intangible asset(s) being valued in the hands of its current owner. Note that there may be circumstances where there are certain intangible assets that are inseparable and, consequently, need to be valued together. In the early days of the internet, for example, website URLs were considered to be inseparable from the related trade-marks and were generally valued together.

This value is best considered as the difference between:

- The entire value of the business with all assets; and
- The entire value of the business with all assets other than the intangible asset(s) being valued.

Referring back to the previous example, if the company lost a patent, it could have an adverse impact on the value of trade-marks, or if the company lost a trademark it could have an adverse impact on the value of a patent. Accordingly, the aggregate sum of the value of all intangible assets under the value in use perspective (together with the value of the tangible assets) could exceed the aggregate value of the business due to double counting and is therefore not meaningful in this regard.

However, it has a significant benefit to management in that the value in use perspective allows management to identify those intangible assets that contribute most to the value to the business or, put another way, would have the most significant adverse effect on the business if those intangible assets were lost.

Implicit in the above is that in the value in use perspective, other assets can contribute to an increase in the value of an intangible asset such that its resulting value may exceed fair market value (discussed further below). Conversely, in some circumstances, an intangible asset may be used sub-optimally by a company, and its fair market value would exceed its value to the company. In such a situation, the optimal outcome would be the sale of that intangible asset, but management may consider the asset to be strategically significant for other reasons.

The break-up perspective

In contrast to the value in use perspective, the break-up perspective considers the corporation as a collection of individual assets, each of which has a value that can be separately realized if it were sold in isolation on the open market separate from the remainder of the assets of the business.

74. Note that some companies may consciously develop and manage intangible asset with the intention of licensing them out to third parties rather than using them in the business, this is generally the exception and is beyond the scope of this discussion.
75. “ISO 20671:2019 Brand evaluation – Principles and fundamentals,” ISO, International Organization for Standardization, 2019, <https://www.iso.org/standard/68786.html>.

The advantages of this perspective are as follows:

- It provides information as to downside risk to shareholders and other stakeholders in the event of a company's financial failure in the same way that the extent of tangible asset backing value provided downside protection in the event that a manufacturing company were to fail; and
- For regulated activities, such as sales of intangible assets in non-arm's length transactions between tax jurisdictions, the break-up perspective provides a more meaningful benchmark value. While investment value, used in the value in use perspective, is meaningful to the company, each company is likely to have different investment value. Conversely, there is only one fair market value for an asset⁷⁶.

The following are examples of those that typically employ the break-up perspective:

- In-house counsel - who considers what can be done, legally, to protect those assets that are capable of protecting. These assets can comprise, amongst others, intellectual property rights (including patents, trade-marks and copyright), contractual rights (including both contracts with third parties through, for example, exclusive supply agreements, exclusive distribution agreements, and non-disclosure agreements as well as internal through, for example, non-compete agreements, non-disclosure agreements (regarding trade secrets for example), employment agreements and fiduciary obligations) and other forms of property rights;
- Tax authorities - who generally consider each individual asset and, for example, when those assets are transferred across borders, will require that a fair market value be assigned to the asset being transferred⁷⁷; and
- Accountants and valuers - who consider each separable asset when determining the value to be assigned to assets acquired as part of a transaction under the accounting rules governing purchase price allocation.

By contrast, the disadvantage of the break-up perspective is that, as implicit in the definition of fair market value, it anticipates a transaction - a sale - of the asset being valued. Accordingly, for it to be applicable, the asset being valued needs to be saleable. Specifically, it needs to be legally identifiable and transferable.

For certain intangible assets, this presents no issue. A patent can be valued in the hands of its current owner, can be legally identified, and can be sold.

For a brand, however, this can present an issue. Recall that a brand is defined as an "intangible asset, including but not limited to, names, terms, signs, symbols, logos, and designs, or a combination of these, intended to identify goods, services or entities, or a combination of these, creating distinctive images and associations in the minds of stakeholders." While certain legally identifiable and saleable components of a brand exist, such as a trade-mark, for many companies the brand is embodied in so many aspects of product manufacture, quality, customer sales experience, after-sales service and customer expectations, that, a brand typically cannot be fully transferred without a complete sale of the company. Accordingly, even if it is possible, it is very difficult to determine the fair market value of a brand.

What do the courts consider?

While the precise remedies will vary in each legal jurisdiction, generally, where a court finds that there has been an infringement of the legal rights of a plaintiff, the court usually seeks to award financial remedies to put the plaintiff back in the same economic position that it would have been in had the infringement not occurred.

To do so requires a specific emphasis on the use that the plaintiff actually did, and would have, made of the asset in question and how that use was adversely affected by the infringement. Accordingly, the appropriate consideration is the value in use perspective to identify how the investment value of the plaintiff was affected by the infringement.

In certain cases⁷⁸, however, it may have been possible for the plaintiff to have mitigated its losses through an open market transaction to acquire another a replacement asset that would have allowed it to continue to operate and achieve the same level of profits. If the court finds it could have, and should have, done so, then it is the fair market value (cost) of this alternative mitigation action that would be appropriate to consider in the mitigation action.

To illustrate, the loss of Company A on the sales of its single patented product is available for compensation from Company B (value in use perspective). However, this may need to be reduced by the profits that it could have made (value in use perspective) had it paid a license fee and licensed in the alternative product (fair market value license).

76. Fair market value is defined as "the highest price, an open and unrestricted market, between willing and knowledgeable parties, acting at arm's length and under no compulsion to act, expressed in cash or cash equivalents." While, in reality, valuers will determine a range of fair market value, the principles underlying fair market value are agnostic to who the seller and buyer are and provide a more consistent basis for value.

77. Readers are referred to the August 2019 ruling of the Ninth Circuit in *Amazon.com Inc. & Subsidiaries v. Commissioner* which highlights the issue that, in the matter at issue, the compensable value of intangible assets was limited to the value of "independently transferable assets" and was not intended to embrace "residual-business assets" such as goodwill and going concern value.

78. Note that this paragraph is included for completeness as it applies in principle. However, for intangible assets this will likely only apply in very specific circumstances.