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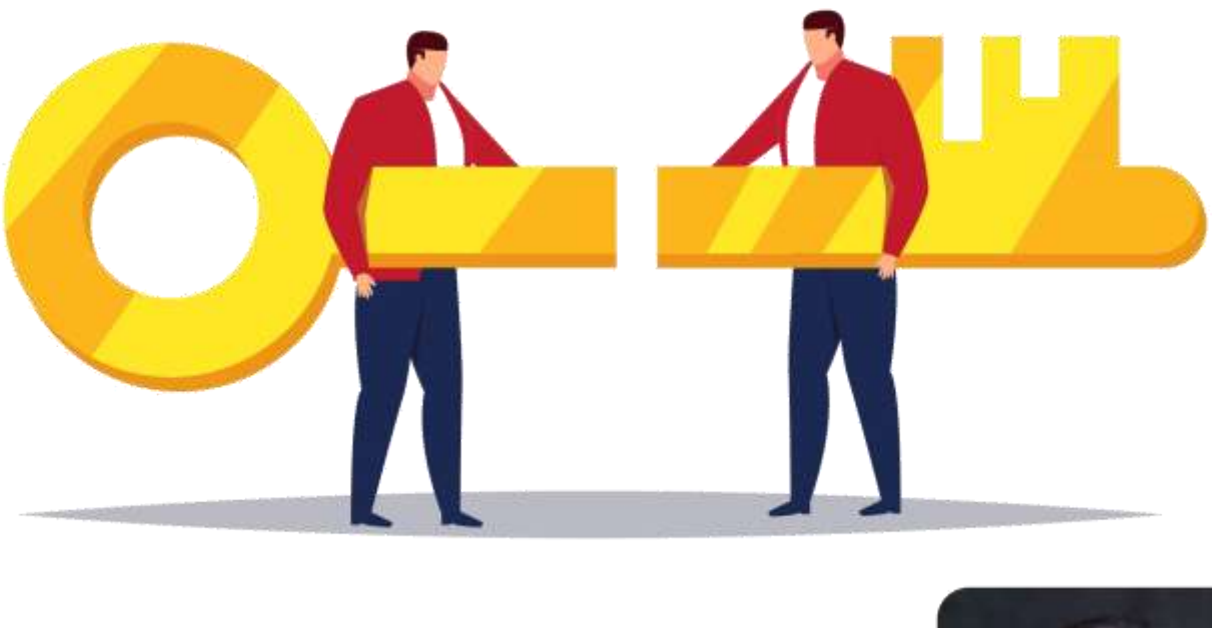
IP VALUATION
AS A VALUE-ENHANCEMENT IN CORPORATE
MERGERS & ACQUISITIONS



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IP VALUATION AS A VALUE-ENHANCEMENT IN CORPORATE MERGERS & ACQUISITIONS (M&A)

INTRODUCTION

It is incontrovertible that business and financial transactions are undertaken for profit-oriented objectives. For instance, assets will be purchased for the cash flows they will ultimately generate; not to decorate the portfolio of the purchaser. Therefore, knowing what an asset is worth and what determines that value is a prerequisite for intelligent decision making i.e. in choosing assets to comprise a portfolio, deciding the appropriate price to pay or receive for an asset, and in making investment and financing choices when running a business.[1]

Intellectual property (IP) shares many of the characteristics associated with real and personal property. For example, intellectual property is an asset, and as such it can be bought, sold, licensed, exchanged, or gratuitously given away like any other form of property.[2]

Valuation therefore plays a critical role in the financial investment making decision process. The obvious question then is what is valuation? Valuation refers to the process of ascertaining the inherent worth of an asset which will form the basis of the price a buyer is willing to pay for that asset.

In corporate M&A deals, where valuation underpins the commercial transaction being consummated, failure to accurately assess and determine the inherent worth of an

1 Available at <http://pages.stern.nyu.edu/~adamodar/New_Home_Page/background/valuation.htm> Last accessed July 20, 2018

2 Available at <https://faculty.darden.virginia.edu/chaplinskys/PEPortal/Documents/IP%20Valuation%20F-1401%20_watermark_.pdf

asset or company may lead to obtuse pricing on the side of the buyer and seller.

An illustration of this is the case study presented by the Broadcast.com case. I***n 1999, Yahoo bought a financially unsuccessful internet radio startup – Broadcast.com – for a reported 5.7 billion dollars, in one of the biggest deals in internet history. Broadcast.com seemed to be a successful company, with huge internet presence and cutting-edge technology. Yahoo's valuation of the company was based on its overly bloated "performance on paper" and an inaccurate forecast of internet trends and online consumer behaviour. In fact, Broadcast.com had been steadily losing money before the acquisition. The deal turned out to be a massive flop. The service has since***

been shut down, along with all its derivatives. In hindsight, Broadcast. com was not even worth $100,000,000.

A cornerstone of investment and financial decision-making thus is that; you must never pay more for an asset than it is worth or, inversely, you must never accept less for an asset than it is worth. Consequently, perceptions of value must be backed up by reality; a reality which postulates that the price paid or received for an asset must reflect the cash flow it is expected to generate sooner or later.[3]

THE IMPORTANCE OF IP VALUATION IN CORPORATE M&A

In 1998, German carmaker, Volkswagen, purchased the assets of Rolls Royce and Bentley for about $900,000,000. Supposedly, Volkswagen had purchased everything it needed to begin the manufacture of the Rolls Royce automobiles, which was a key objective of the entire acquisition exercise. However, Volkswagen did not realize until after the deal was closed, that the IP assets it had just purchased did not include the right to use the Rolls Royce Trademark! The Rolls Royce airplane engine company had licensed the right to use the "Rolls Royce" mark

to the defunct auto manufacturer under a license that terminated in the event of the latter's sale to any third party. At the point of Volkswagen's purported purchase of the assets of the Rolls Royce automobile company, the

3 ibid

license to use the mark terminated by operation of law and full ownership of the mark reverted to the Rolls Royce airplane engine company who subsequently sold it to BMW, an arch-rival of Volkswagen. Thus, Volkswagen had acquired everything necessary to build Rolls Royce cars except the right to use the Rolls Royce mark, which effectively made the entire acquisition exercise a near-failure.

The purpose of acquiring Rolls Royce automobiles was not just to build plants; it was to own the right to use the Rolls Royce mark. The value of $900,000,000 was not just for plants and equipment; it was for the right to manufacture vehicles that bore the Rolls Royce trademark; plants and machinery were only incidental to this objective. Failure to obtain the IP right made the entire acquisition exercise redundant, If Volkswagen had realized that the acquisition would not include the right to use the trademark, it would either have valued the company at less than half of the price paid, or it would not have bothered with the acquisition at all.

It is really simple: The price Volkswagen offered for the company was a reflection of its value for the brand, being a function of the perceived cost of attempting to create from scratch, a luxury brand of its own.

Without valuation, there can be no adequate financial arrangement in Corporate M&A.

How will the buyer decide on an adequate offer for the target firm or asset? How will the target firm decide on an adequate value for itself or its assets, below which acceptance will be impossible?

The above example also highlights the role of IP valuation in Corporate M&A as well as the integral role IP due diligence plays within transaction. In Corporate M&A, valuation and IP due diligence must work hand in hand to reflect an accurate value for the target firm.

There is a significant difference between valuing a business as a growing concern and valuing a business on the basis of its assets. As a going concern, its valuation is based not only on existing investments but also on expected future investments and their profitability. In an asset-based valuation, focus primarily is on the existing assets with the value of each asset estimated separately. A particular example of asset-based valuation is liquidation valuation, where assets are valued upon the presumption that they have to be sold as soon as possible. The urgency associated with liquidating assets often results in a discount on the value. How large such discount will depend on the number of potential buyers, the urgency of the transaction, the characteristics of the asset and the state of the economy.[4]

When undertaking a valuation for the purposes of Corporate M&A, IP due diligence is of utmost importance. All known models of valuation will prove inaccurate, no matter how much care and expertise is involved, where due diligence is not performed.

4 http://pages.stern.nyu.edu/~adamodar/New_Home_Page/background/valintro.htm?

As evidenced in the example of Volkswagen above, IP due diligence can be the difference between a successful or failed acquisition; regardless of how much money the acquiring party has at its disposal.

During valuation for a Corporate M&A, one must seriously consider the context of the IP asset, i.e. the operating environment within which such asset will be deployed. Sometimes, an IP asset may look incredible on paper, but the operating environment may be such that will hamper or restrict the potential revenues from such asset. For instance, if Company X develops an online platform for streaming television shows live in Nigeria, via mobile phone, this seems like cutting-edge innovation. However, any valuation of this innovation for the purposes of acquisition must consider the “context” or operating environment which include: high costs of internet data, the relative ease and convenience of watching TV shows via television as opposed to the inconvenience of a small mobile screen, the poor quality of TV shows available locally etc. These are important considerations that IP due diligence will help reveal which will then feed into the valuation criteria to be adopted when pricing the innovation.

Also, of extreme importance in valuation for corporate M&A is the quantification of the remaining economic life of the IP asset, and its decay rate. IP assets have different lifespans. Typically, the legal life of an asset[5] is often shorter than the economic or useful life of the same asset. The economic life of an IP asset is the period during which the asset will continue to generate income. The decay rate is the rapidity with which the asset approaches the end of its useful life. For instance, trademarks practically last forever, and this must be a determining factor in valuation exercises. However, the economic life of copyright varies wildly between different sub-categories of IP. While the copyright in books, lyrics and other texts may have long economic lives, the same cannot be said for copyrighted Software, which typically has a maximum economic lifespan of three years before they are replaced by newer technology.

5 As stipulated by statute or contract

IP due diligence reveals the inherent realities of IP assets, which may not be apparent at first instance, and help a purchaser or IP owner to reach a more accurate value of his or her asset.

METHODS OF IP VALUATION

AAll methods of valuation of IP assets fall under three main heads:

1. **The Market Approach.** This seeks to assign value to IP assets by comparing the price at which comparable assets are changed under similar circumstances. This is as opposed to running an intrinsic valuation on the IP asset itself. The market approach is most applicable where; an active market exists for the asset; there is a significant number of similar

asset exchanges in the recent past; price information on similar asset exchanges is available to the public; the exchanges are between independent parties who enter into the subject transactions without compulsion. There are challenges though, or this approach is difficult enough when valuing tangible assets because no two transactions are ever exactly comparable. In valuing items of IP, the search for comparable market transactions becomes almost futile since, usually, most IP sales are only a small part of a larger transaction and details are kept extremely confidential.[6]

2. **The Cost Approach.** This estimates the value of an IP asset by comparing such asset with the cost to replace it or recreate another identical or similar asset. The fundamental assumption underlying the Cost Approach is that the cost to acquire[7] an IP asset should not significantly outweigh the cost of developing and utilizing a similar asset, and both should correspond with the economic value that the asset can provide during its economic life. This "cost to create" or "cost to replace" approach ignores changes in the time value of money, maintenance and has very little to commend itself other than ease of use.[8]

3. **The Income Approach.** This is based on the net present value of the future economic income expected to be received by the owner during the remaining useful life of the IP asset.[9] The most prevalent technique under this approach is the Discounted Cashflow Valuation (DCV). Using DCV, the value of an IP asset is the present value of the expected cash flows from the asset, discounted back at a rate that reflects the risks

6 K. King, The Value of Intellectual Property, Intangible Assets and Goodwill. Available at <www.wipo.int/sme/en/documents/value_ip_intangibe_assets_fulltext.html> Last accessed July 20, 2018

7 https://www.fidelity.com/learning-center/trading-investing/fundamental-analysis/earnings-dividends-v

8 ibid

9 G. Podolsky, Esq. The Importance of Valuing Intellectual Property from an Attorney's Perspective. Available at <https://www.carltonfields.com/files/Publication/681d4872-33c7-4b28-b99f-453c3d47d9e6/Presentation/PublicationAttachment/eb3af5a1-2279-43bf-9226-497d8a681bd5/Podolsky.pdf> Last accessed July 20, 2018

associated with these cash flows.[10] Using this method, assets with predictable cash flows tend to be preferred to assets with volatile cash flows. The discount rate is a function of the risk associated with the cash flows: high-risk assets will carry higher discount rates, thereby reducing their present value. DCV allows for the assumption that $1 in your pocket today is worth more than $1 in your pocket next year. It makes room for the time value of money by adjusting expected future returns to today's monetary values by using a discount rate which compensates for risks, including expected rates of inflation.[11]

In practice, the three basic approaches

10 <http://pages.stern.nyu.edu/~adamodar/New_Home_Page/background/valintro.htm?>

11 K. King, The Value of Intellectual Property, Intangible Assets and Goodwill

analyzed, have been recognized and adopted during transactions.[12]

IP VALUATION IN NIGERIA CONTEXT: KEY TAKEAWAYS

In April 2018, Yudala, merged acquired Konga to become Africa's largest e-commerce platform. The acquisition took effect from May 1, 2018, after which both companies became one entity, operating under the KONGA brand name. Before the merger, Konga was Nigeria's second largest online mall, second only to Jumia. Yudala was also a strong online and offline retail business with an expansive network of fully stocked offline stores. Together, they have become Africa's largest online e-commerce business.

The two companies in the above example; Konga and Yudala, are

12 Teller v. Teller, 53 P.3d 240 (Hawaii 2002)

online businesses whose existence revolve around the utilization of their IP assets. The merger is historic in the economic context of Nigeria, where corporateacquisitionstypicallyinvolve businesses in the banking, oil and gas, or FMCG sectors who ordinarily place more emphasis on tangible assets. The acquisition of Konga by Yudala was not only unprecedented from a sectoral perspective (as it involved two businesses operating in the e-commerce space) but also the fact that the acquirer changed its brand name to that of target because of the inherent IP value of the target.

This underscores the rising importance of IP in the Nigerian economic landscape and hints at a future, where the value of a company in Nigeria will not be based solely on its tangible assets and immediate cash flow, but on the value of its IP portfolio.

However, in the area of IP valuation, there has been little/slow progress whatsoever in Nigeria. Mergers and acquisition continue to be motivated by factors other than Intellectual Property, and the value of IP in such transactions is typically measured as a subset of the overall value of the company, in terms of cash, stock value, shareholdings and tangible assets.

AMCON[13] did not bother about the inherent value in the trademark "Bank PHB" before summarily withdrawing its license. The owners and management of the company which used to be known as Econet Nigeria[14] have not shown much regard for the value of the trademark rights in the company's name, as evidenced in the company's repeated name change: The Company has changed the brand name 5 times!!!.

Given the above, the following prescriptions should be adopted by prudent Nigerian businesses:

1. Nigeria businesses should identify all their IPR used in generation of business through IP audit and protect IPR by ensuring registration.
2. Periodically conduct an audit of its IPR, value them and regularly combat infringement of the IPR in order to keep its value intactin order to keep its value them and regularly combat infringement of the IPR in order to keep its value intact.
3. International accounting best practices should be adopted whereby, the value of a company's IP portfolio would not be subsumed under the value of its tangible assets, but would be,

13 The Assets Management Company of Nigeria

14 Now Airtel Nigeria

measured separately, such that they may be the subject of an acquisition, independently of the parent organization.

4. Organizations should undertake extensive IP management, to catalogue all IP assets, after which each asset should be valued appropriately.
5. IP lawyers and accountants should be trained and educated on IP valuation systems and methods.
6. Lawyers and accountants, in a merger and acquisition, should insist on the recognition of IP assets as separate and independent of other assets and should place a price tag on each asset.

CONCLUSION

IP valuation is crucial to its exploitation or deployment for any form of financial gain. Without valuation, commercial transactions involving IP would be frustrating, at best, and inherently inequitable to one or both parties. Valuation is, therefore, a must for every IPR holder since it is key to obtaining adequate financial benefit.

For further information, questions and clarifications, please contact:

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