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Valuation Report

Business Valuation Trends and Strategies
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Technical Topics

Know the Value of Your Company's Intellectual Property

Depending on the nature of the business, intangible assets can represent an enormous percentage of a company's value. In fact, Ocean Tomo's most recent *Intangible Asset Market Value Study* indicates that intangible assets account for over 80 percent of the market value of the assets held by companies in the S&P 500.

Intellectual property (IP) — a subset of intangible assets that includes patents, trademarks, copyrights, designs and trade secrets — is often what differentiates a company and gives it a competitive edge. However, accounting rules preclude recording most of these assets on the balance sheet, so managers and investors are often lacking data that would help them understand the value of their company's IP.

Driving Economic Benefit

Like any asset, the value of IP depends on its ability to generate an economic benefit to its owner. For example, a trademark might allow a company to charge a premium price. A proprietary process might allow a manufacturer to be the low-cost leader. In both of these examples, IP provides its owner with incremental profits or lower risk.

Most IP valuation occurs in the context of transactions, litigation and compliance reporting. However, owners and executives may get the most benefit by incorporating IP valuation into their broader decision-making process.

Some of the factors that influence IP value include:

- **Extent of advantage:** IP is more valuable to the extent it increases demand for a product or reduces the cost of production.
- **Extent of protection:** IP is more valuable to the extent it provides a stronger exclusive right.
- **Stage of development:** IP that is fully developed and is enjoying or contributing to commercial success is more valuable than IP that's in its infancy or is no longer protected.
- **Market size:** IP is more valuable to the extent it addresses a larger or faster growing market than if it addresses a smaller or slower growing market.
- **Manner of use:** IP may be more valuable to the extent its owner can exploit it directly rather than license it to others. However, direct exploitation may entail greater risks than licensing.

Factors that affect license value include whether the license is exclusive or non-exclusive, transferable or non-transferable, long-term or short-term, and broader or narrower with regard to geographic and field of use restrictions.

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Looking Ahead

Who's the Right Buyer for Your Business?

When it's time to exit the business, many owners already have a plan in mind. Some are set on transitioning ownership to the next generation, leaving their children a profitable legacy. But if the next generation isn't willing or able to take the helm, sellers have several other options to realize value, including:

- **Selling to key management** – An exiting owner might like to offer the management team an opportunity to buy the business. This provides a way to reward loyal employees and increases the likelihood that the business will continue.

  Because the parties know each other, there may be some price flexibility and, as a "friendly" transaction, the owner may consider financing the deal and being paid over time. However, clear leadership and an honest assessment of the company's debt capacity are a must. The company must have a strong track record of generating healthy cash flows so that the owner can meet his or her financial objectives.

  Further, the seller may need to provide "seller paper" to bridge a financing gap. If so, the seller assumes risk, and may not realize the full benefit of the sale at the time of the transaction.

- **Selling to employees** – Employee stock ownership plans (ESOPs) are tax-qualified retirement plans that invest primarily in the stock of the employer. The ESOP typically buys all the company stock, and employees have individual ESOP accounts invested in the employer's stock.

  Selling to an ESOP gives the owner a ready market, as well as a way to diversify holdings and preserve wealth. When correctly used, ESOPs also offer significant tax benefits. However, ESOPs can be costly to maintain, with heavy administrative burdens, and they also require a yearly valuation.

- **Selling to a financial buyer** – Private equity (PE) firms typically seek what they consider to be undervalued but scalable companies. Their goal is to make money, which can be a benefit to the owner, who may keep an equity stake in the deal.

  The upside for sellers is that they can cash out — fully, partially or over time — to diversify their holdings and put their company in the hands of institutional professional operators. To the extent that an equity position is rolled over, owners may receive "two bites of the apple," having sold a controlling interest to the PE firm, and then getting another payout when the PE firm sells the company.

  But, as the *New York Times* aptly put it, "Private equity firms are not sentimental." Financially motivated buyers are more likely than owner-entrepreneurs to take risks and make changes in business operations. Favorite employees may be sacked. In a year or two, the company may not resemble what the owner took years to build.

> *If the next generation isn't willing or able to take the helm, sellers have several other options to realize value.*

- **Selling to a strategic buyer** – Strategic buyers are interested in buying companies that have synergies with their existing businesses. With a strategic acquisition, competitors or companies in the same industry vertical may be able to fill a production niche, expand their market or simply take a competitor out of the picture.

  Because of this motivation, strategic buyers may be willing to pay more than other buyers. However, there are some downsides. For example, the strategic buyer may purposefully kill the company, which may be unpalatable to the seller. In addition, due diligence required at the front end of the deal — even under a confidentiality agreement — lands in the hands of a potential competitor.

Finding the right buyer is a process. Even the definition of "right" depends on the owner's goals. Be sure to ask your financial advisors for their input. And remember: To maximize value in any sale, the structure and terms of the deal are just as important as the price. ■

Our firm has helped many owners sell their businesses. Let us help you think through your options.

Valuation Audits

How to Work with the IRS

Valuations are professional opinions. Even when presented by experienced experts and based on credible facts and reasonable calculations, there's always some gray area. Therefore, it's not unusual for different valuation professionals to disagree about their conclusions.

But when the IRS disagrees with a valuation conclusion, an adjustment or audit may follow. Certain types of valuations are of particular interest to the IRS. For example, according to the *2012 Internal Revenue Service Data Book*, the IRS scrutinized estate tax returns at close to a 30 percent rate of examination.

When working with the IRS to resolve a valuation issue, the smartest course of action is to let the valuation professional manage the discussion and address any questions with the IRS directly. Here are some best practices valuation professionals typically follow when the IRS comes calling:

- **Speak IRS language.** Before meeting with an IRS representative, the valuation professional will immerse himself or herself in the IRS point of view on the topics in question. For example, if the issue involves a discount for lack of marketability (DLOM) — one of the most significant adjustments associated with valuation — the valuation analyst will be prepared to deliver the information requested as indicated in the IRS's own *DLOM Job Aid Report*.

- **Answer their questions.** The audit letter from the IRS typically indicates which issues the agency is concerned about. The valuation analyst can ask clarifying questions to prepare for the audit meeting, and produce documentation to address specific challenges. In addition, the analyst may review recent court cases to further understand the IRS position.

  Note that it's not unusual for confusion about the applicability of specific court cases to arise. The valuation professional can often illustrate how "this" case's facts don't align with "that" case's facts, thus undermining the challenge.

- **Request technical assistance.** Most IRS audits start with an IRS agent. But if the matter is particularly technical from a valuation standpoint, the agent may not be equipped to understand the complexity of the issue. The IRS employs credentialed business valuators who can be assigned to the case. Requesting technical expertise is a completely reasonable step in the course of the discussion.

- **Be respectful.** The old adage that you "catch more flies with honey than with vinegar" holds true here. IRS agents have jobs to do — being rude or obstinate gets a business valuation professional nowhere. If the relationship with the IRS agent assigned to the case becomes untenable, it's fine to diplomatically escalate the issue to the next level of management.

- **Use an ounce of prevention.** Obviously, it's preferable to avoid an IRS audit, if possible. While there are no "sure" ways to do so, using a credentialed valuation professional is a first step. An experienced valuator is likely to produce a well-written, well-documented valuation report that can stand up to IRS scrutiny. A thorough, reasoned valuation that follows AICPA standards gives the IRS less to pick on.

A valuation audit may not be pleasant, but a good valuation analyst can significantly reduce the pain of the audit and help you get the best results possible. ■

Our firm regularly works with the IRS to resolve issues. Let us know how we might assist you.

Intellectual Property

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- **Enforcement cost:** The decision to pursue and maintain IP rights can be significantly affected by enforcement costs.

Calculating Value

All of these factors and others, such as the cost of developing IP, are considered when assessing the IP's value. The most common way to value IP is to determine its ability to generate future cash flows and then discount those cash flows to present value based on their risk.

Assessing the value of IP relative to "comparable" assets is frequently difficult. But as an additional data point, valuation professionals sometimes turn to online IP marketplaces, including Intellectual Property Exchange International (IPXI), Tynax and yet2. These marketplaces list IP for everything from medical treatment methods to software applications and consumer goods.

Similarly, services such as ktMINE, RoyaltySource and RoyaltyStat are a source for royalty rates for all types of IP. The United States Patent and Trademark office is another source of relevant information.

Owners and managers can improve profits and lower risk, and investors can improve returns, by gaining an understanding of the value of a company's IP and the drivers of that value. An IP valuation professional can guide owners and investors through this process efficiently. ■

We are experienced in intellectual property valuations. Contact us today to discuss your needs.

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Normalization Adjustments Reflect True Performance

Valuation professionals often make adjustments to income or expenses to remove any distortion of the company's operating performance. In other words, to reflect a realistic value, the analyst "normalizes" the company's cash flows by extracting any out-of-the-ordinary expenses or income. These adjustments give a prospective buyer a more accurate picture of what to expect in the future.

Among the most common normalization adjustments are:

- **Reasonable compensation** – Owners may pay themselves higher or lower salaries in order to minimize tax liabilities, influence the company's cash flow or value, or simply to conserve cash for a rainy day. Compensation must be normalized to reflect the salary and benefits non-owners would be paid to do the same job.

- **Related party revenues or expenses** – Closely held businesses often have lease or management fee arrangements with related parties. For example, the business owner may also own the company's building, warehouse or other property and rent it to the company above or below market rate. This rent must be adjusted to reflect what the company would pay or receive from an unrelated party. Similarly, loans to or from related parties or affiliates may need to be reclassified.

- **Non-operating assets and excess assets** – For valuation purposes, the financial statements should present the assets, liabilities, income and expenses of the company's core operations. Therefore, non-operating or excess assets and related debt, income or expenses should be excluded.

Calculating normalization adjustments is complicated, and the purpose of the valuation and the standard of value can change their impact. In addition, normalization adjustments may differ if the valuation is for a controlling interest versus a minority interest.

It is wise to rely on a skilled valuation professional who can properly benchmark, support and document his or her calculations. ■

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