

# Patent Valuation

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BMI Appraisals Limited

**P**atent is a critical component of intellectual property and intangible assets. In general, patent is an invention or process that has been disclosed and registered with a relevant authority. The registration is to enable the register to have an exclusive right to prevent others from using or exploiting the patent in a territory for a specific period of years.

In valuation of patents, a comprehensive process will be adopted to discover the linkage between a patent right and its economical value in the markets. This needs to reflect the commercial reasons for owning and transacting the patents and patent portfolios.

Valuation of patents is required for several reasons, such as acquisition, licensing, sale, joint venture, intellectual property management and patent litigation.

## Why valuing patent is important?

Innovation is becoming the core competitive advantage today. The protection of innovation may create durable corporate success. Patent is therefore considered to be one of the success factors for company in any size and industry. Patent also draws interest of investors and stakeholders, from the aspect of increasing capital requirements, and growing exploitation opportunities in international financial markets. Thus, valuing intangible assets like patents is an important element of strategic management and is constantly increasing in significance.

## Patent in a company

According to a survey on the top 500 patent applicants<sup>1</sup>, more than 90% of the respondents agreed the innovations and patents are critical for corporate success. They also revealed innovative products accounting for 66% of their turnover and 60% of their profits. Patent plays an important role to protect the innovations. 58% of the interviewees confirmed the importance of patents.

## Commercial application of patent valuation

### ■ Merger and Acquisition Planning

Patent valuation techniques now play a significant role in merger and acquisition activity. Potential acquirers like companies with patents and bankers, increasingly use patent valuations to provide comfort that the price being paid for a company can be substantiated by reference to the value of specific intangible assets as well as the tangible assets being acquired.

### ■ Collateralized Borrowing

As patents have increasingly been recognized as assets, the opportunity to use them to back up specific borrowing lines has increased, especially in the US where companies as significant as Disney have borrowed major sums with their patents.

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<sup>1</sup> The survey was conducted by the Institute of Technology Management at the University of St.Gallen, Switzerland and its innovation and intellectual property management advisory spin off BGW.

### ■ Litigation

In the case of infringement proceedings, the courts would undertake a valuation of the patent that is in concern in order to arrive at the amount of an appropriate claim or to establish a reasonable royalty rate to award in lieu of damages.

### ■ Licensing Agreement

Patent valuation provides a basis in determining a patent licensing rate for optimal exploitation of the patent asset through licensing the patent to third parties. The approach determines the fair split of the economic benefit from the patent between licensee and licensor for the use of the patent.

## Technical application of patent valuation

The Hong Kong Accounting Standard 38 (HKAS38) requires organizations to record intangible assets on their financial statements during a business combination event. Further, internally generated patents are not recognized as intangible assets unless they are being acquired.

## Methodologies on patent valuation

### ■ Cost Approach

The Cost Approach determines the value of a patent by deciphering the overall cost in re-creating a patent, including market testing, promotion and product improvement. This approach applies either the historical cost or the replacement cost in finding the value of a patent. The historical cost determines the value of the patent as the sum of accumulated costs expended on the patent to date; while the replacement cost estimates the cost that would be incurred to replace the asset if it is destroyed. However, cost approach is seldom used as a standalone valuation method.

### ■ Market Approach

The market approach focuses mainly on comparable patents in recent merger/acquisition transactions in determining the value of the patent. This approach may easily be comprehended; however, for this approach to work, one may need to find comparable transactions within the market, and many times these transactions cannot be easily found given the uniqueness of individual patents. Perhaps by chance comparable transactions could be found, but only limited public financial information has been disclosed, and this approach will fail. As such market approach is not a widely adopted method.

### ■ Income Approach

The Income Approach adopts an assumption that the patent value is determined by calculating the present value of the net economic benefit over the life of the asset. There are three commonly used methods under income approach on patent valuation, namely incremental cash flow method, multi-period excess earnings method, and relief-from-royalty method. Among these three methods, a more commonly used method recognized by technical authorities worldwide is the relief-from-royalty method.

#### 1. Relief from royalty method

This method positioned as a simple method which considers practical application aspects. This method focuses on the cost could save by owning the royalty instead of leasing it. This valuation method is common to value patents, utility models and trademarks.

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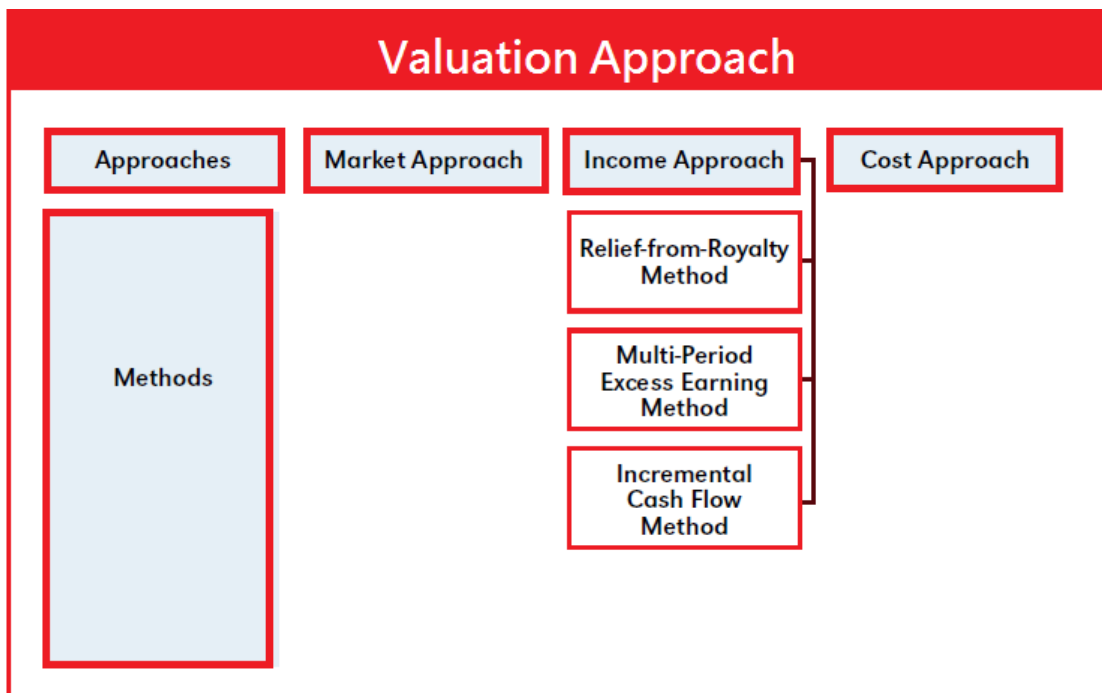
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## 2. Multi-period excess earnings (MPEE) method

This model estimates the free cash flow derived from the intangible asset, deducted by the value of supporting assets, such as fixed assets and working capital. The result can be viewed as the value solely contributed by subject intangible asset.

## 3. Incremental Cash Flow method

This method measures the economic benefit provided by subject asset. An intangible asset is valued based upon the additional profit or cost savings that the owner of the intangible asset will achieve in relation to if they did not own the intangible asset.



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