



Emerging Issues in Online Entertainment & Interactive Gaming Operations

November 24-26, 2002

San Juan, Puerto Rico

Valuing Intellectual Property and Online Business Activities

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Topics

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- **Definition and Types of Intellectual Property**
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 - Valuation of Start-up Operations Using Established IP
 - Relevance of Brand/Domain Name
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Overview of Internet's Role in Gaming

“From a business standpoint, Standard & Poor’s views Internet gambling as both a threat and an opportunity for traditional casino companies. Placing bets from a computer at home offers the obvious advantage of convenience and is potentially a low-cost way for gambling companies to conduct business. Some of today’s large casino companies have the financial clout and brands (e.g., Caesars, Harrah’s) that could make them formidable participants online.”

[For electronic copies of this entire industry survey, please see speaker]

Source: Standard & Poor’s, August 15, 2002/ Lodging & Gaming Industry Survey





Definition and Types of Intellectual Property

- **Intangible assets are all the elements of a business enterprise that exist in addition to monetary and physical assets. Intangible assets can be categorized as follows:**
 - *Rights*
 - Contractual Rights, Rights of Franchisee and Franchisor
 - *Relationships*
 - Customer Relationships, Distributor Relationships
 - *Grouped Intangibles*
 - Going Concern Value, Goodwill
 - *Intellectual Property*
 - Patents, Trademarks, Copyrights, Trade Secrets, and Know-How

Source: Gordon V. Smith and Russell L. Parr, Valuation of Intellectual Property and Intangible Assets, Second Edition, 1994 by John Wiley & Sons, Inc.





Definition and Types of Intellectual Property

- **The Financial Accounting Standards Board (“FASB”) has set specific recognition criteria for intangible assets:**
 1. *arise from contractual or legal rights (even if it cannot be separated and/or sold), or*
 2. *capable of being separated or divided and sold, transferred, licensed, rented, or exchanged*
 1. Regardless of intent
 2. Either individually or with a related contract asset or liability

- **FASB examples of Intangible Assets that meet criteria for recognition apart from goodwill:**
 - *Marketing-related*
 - *Customer-related*
 - *Artistic-related*
 - *Contract-based*
 - *Technology-based*



Definition and Types of Intellectual Property

□ Major Online Business Intangible Assets

- *Marketing-related*
 - Brand/Domain Name
 - Exclusive Distribution Rights

- *Customer-related*
 - Subscriber Base

- *Contractual-based*
 - Referral Agreements
 - Regulatory Environment Driven Agreements/Contracts

- *Technology-based*
 - Payment System
 - Operating Software



Intellectual Property Valuation Methods

□ IRS Guidance

- *IRS Defines Fair Market Value as the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts (Estate Tax Regs., Sec. 20.2031-1(b); Rev. Rul. 59-60, 1959-1 C.B. 237). Set up holding company (IPHC)*
- *Going concern compared to Liquidation Basis: subtle difference in view may result in significant value difference*

□ FASB Guidance

- *FASB Statement 142 defines Fair Value as the amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.*

Source: *Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, June 2001.*



Intellectual Property Valuation Methods

□ Income Approach

➤ *Royalty Savings Approach*

- Based on benefit of owning intellectual property
- Determine arm's length royalty rate
- Present value of after-tax royalty savings
- Adjust to include tax benefit due to amortization of acquired IP

➤ *Discounted Cash Flow Method*

- Estimate cash flows of the business
- Calculate discount rate
- Subtract capital charges for other assets
- Present value of cash flows



Intellectual Property Valuation Methods

□ Market Approach

- *Actual market transactions of comparable intellectual property*
- *Comparability can be an issue*
- *Availability of data*

□ Cost Approach

- *Replacement cost or build-up cost*
- *Design-around cost*
- *Return on R&D expenditures*
- *Not always representative of Fair Market Value*





Intellectual Property Valuation Methods

□ Scenario Analysis

- *Appropriate tool?*
 - When there is high degree of uncertainty
 - Size and profitability of future markets
 - Sales will not commence for several years

 - When there is an uneven distribution of returns
 - Overwhelming upside potential
 - Little downside exposure



Intellectual Property Valuation Methods

Data Sources and Reasonableness Tests

□ **Data Sources**

➤ *Royalty Rate Sources*

- PwC Licensing Database
 - Over 3,000 royalty rates compiled from SEC corporate filings and other public documents
- Licensing newsletters and publications
 - Licensing Economics Review
- Franchise guides
- Licensing and academic journals
- Court cases
- SEC corporate filings
- Data provided from client owner of subject IP (other agreements for use of same or similar IP)



Intellectual Property Valuation Methods

Reasonableness Tests

- **Issue: Significant Uncertainty**
- **Compare to Benchmark**
 - *Business value if known*
 - *Revenues*
- **Consider Alternatives to Sale/Ownership of IP**
 - *Cost/time*
 - *Acquisition of similar IP*
 - *Supply/demand of IP*
- **Use Several Models/Approaches**
- **Apply Common Sense/Intuition to Outcome**
 - *Adjust assumptions or outcome based on:*
 - Past experience
 - Industry knowledge





Intellectual Property Valuation Methods

Online Business Activities Intellectual Property

□ Legal Issues

➤ Taxation

- November 2001, Internet Tax Non-Discrimination Act was enacted
- Law extended moratorium on taxes created for online access and transactions until November 2003
- Conflict exists between those who believe the act promotes greater health and growth for the Internet economy and those who believe the act unfairly disadvantages government entities

➤ Security

➤ Privacy

- Online privacy issues
 - Children’s Online Privacy Protection Act
 - US Health Insurance Portability and Accountability Act
 - Graham-Leach-Bliley Act (regulating information collected by financial institutions)

Sources: *The Business Monthly*, “Changes in Internet Privacy Laws Impact Online Businesses”, May 2002;
Advisory Commission on Electronic Commerce: Report to Congress, April 2000





Intellectual Property Valuation Methods

Online Business Activities

□ Valuation Issues

- *High ratio of expectation to achievement when valuing online activities (1)*

- *Selection of Market Comparables remains a challenge*
 - Are the business models of the comparable companies similar to the target company?

- *Consolidation in the Online sector*

Sources: (1) *Business Strategy Review*, 2000, Volume 11 Issue 1, pp 10-20, "Valuing Internet Businesses" by Chris Higson and John Briginshaw



Intellectual Property Valuation Methods

Online Business Activities

□ **Valuation Issues**

- *Income Approach remains the most appropriate valuation method*
 - Challenges are forming reasonable expectations regarding:
 - » Firm's growth potential and nature and size of future market (revenues)
 - » Firm's profit earning potential (margins)
 - » Firm's capital investment requirements (balance sheet structure)
 - » Future competitive landscape





Intellectual Property Valuation Methods

Online Business Activities

□ Income Approach Issues

➤ *Revenue Forecasting*

- Single forecast revenues may not be appropriate due to uncertainty in industry; range of possible outcomes may be wide
- Scenario analysis is an essential tool in forecasting revenues
- Customer retention may be difficult to predict
- Ability of non-online data as useful proxy

➤ *Scalability*

- Are capital expenditures in line with expectations regarding growth in subscriber base (i.e. can the infrastructure handle the subscriber base)?





Intellectual Property Valuation Methods

Online Business Activities

□ Income Approach Issues

➤ *Margin Forecasting*

- Will the business create and sustain a competitive advantage?
- Earnings appear depressed as marketing and customer acquisition costs and development costs (by nature intangible assets) are expensed
 - old economy firms' investments were primarily in monetary and physical assets which are recorded on balance sheets
- The issue is whether these costs will persist and at what level
 - competitors may force evolution of websites, continued expenditures for customer retention, etc.
- How will business operations be geared?
 - the fixed versus variable cost(s) relationship





Intellectual Property Valuation Methods

Online Business Activities

□ Valuing Major Intangible Assets

➤ *Subscriber Base*

- Value using the Income Approach – Discounted Cash Flow Method
 - Determine cash flow as follows:
 - » Estimate revenue attributable to active, existing accounts
 - consider customer churn or turnover
 - ability of non-online data as useful proxy
 - » Deduct transaction expenses, provisions for transaction losses, product development, a maintenance level of SG&A, and a maintenance level of customer service operation expense
 - Deduct capital charges for contributory assets
 - » Fixed assets, working capital, brand/domain name, existing technology and other intangible assets
 - Covert cash flows to present value
 - Apply tax shield benefit



Intellectual Property Valuation Methods

Online Business Activities – Valuing Major Intangible Assets

HYPOTHETICAL EXAMPLE	---Projected---			
	2003	2004	2005	2006
Existing Subscriber Base of Made Up Company				
Retention Rate of Existing Subscribers	NA	75%	50%	25%
Number of Existing Subscribers	100	75	38	10
1) Revenue per Existing Subscriber	<u>\$50</u>	<u>\$51</u>	<u>\$52</u>	<u>\$53</u>
2) Table Drop (Revenue)	\$5,000	\$3,825	\$1,976	\$530
3) Casino Hold Percentage	<u>10%</u>	<u>10%</u>	<u>10%</u>	<u>10%</u>
4) Casino Win	\$500	\$383	\$198	\$53
Costs of Operations (@ 40% of Win)	<u>200</u>	<u>153</u>	<u>79</u>	<u>21</u>
Pre-Tax Earnings	\$300	\$230	\$119	\$32
After Tax Earnings (@ 40% Tax Rate)	180	138	71	19
Allocated to Supporting Assets (@ 20% of Win)	<u>100</u>	<u>77</u>	<u>40</u>	<u>11</u>
Cash Flow From Existing Subscriber Base	\$80	\$61	\$31	\$8
Present Value Factor (@ 20% Discount Rate)	<u>.9129</u>	<u>.7607</u>	<u>.6339</u>	<u>.5283</u>
Present Value Cash Flows	\$73	\$46	\$20	\$4
Sum of the Present Value of Cash Flows	143			
Present Value of Cash Flows Including the Tax Shield Benefit (@ 1.1582 if applicable)	\$166	(Value per Existing Subscriber = \$1.66)		





Intellectual Property Valuation Methods

Online Business Activities

□ Valuing Major Intangible Assets

➤ *Brand/Domain Name*

- Value using the Income Approach – Royalty Savings Method
 - Estimate appropriate royalty
 - » Return on assets method
 - » Comparable royalty rate search
 - » Economic balance sheet approach – comparable company
 - Estimate total revenue for products and services that benefit from brand/domain name
 - Calculate after tax royalty savings by multiplying estimated revenues by royalty rate and appropriate tax rate
 - Convert cash flows to present value
 - » Discount rate will reflect regulatory environment (see table on next page)
 - Apply tax shield benefit



Intellectual Property Valuation Methods

Discount Rate Estimation

JURISDICTIONS OFFERING SOME FORM OF ONLINE GAMBLING LICENSES

<u>Representative Countries</u>	<u>Business Environment</u>	<u>Regulatory Structure</u>	<u>Policy Stability</u>	<u>Telecom Availability</u>	<u>Indicative Risk Premium</u>
Africa					
Comoros	2	2	2	2	20%
South Africa	2	4	3	3	15%
Asia Pacific					
Australia*	2	4	3	4	8%
India*	2	3	3	3	12%
New Zealand	3	3	4	4	10%
North Korea	2	3	3	3	na
Philippines	2	3	3	2	25%
South Korea	2	4	4	3	20%
Vietnam	1	3	2	3	35%
Caribbean					
Antigua	4	3	3	4	15%
Grenada	2	2	3	3	25%
Jamaica	2	4	4	3	15%
Curacao	2	2	3	3	20%
St. Kitts & Nevis	2	2	3	2	30%
US Virgin Is.	2	3	3	3	20%
Europe					
Belgium	3	4	4	3	5%
Denmark	2	4	3	3	6%
Germany	2	4	4	4	4%
Iceland	2	4	4	3	8%
Netherlands	3	4	4	4	4%
Russia	2	2	2	2	25%
Sweden	4	3	3	3	4%
United Kingdom*	4	5	5	4	1%
Isle of Man	4	4	5	4	1%
North America					
Canada*	4	3	4	5	5%
United States*	2	5	3	4	2%
Latin America					
Argentina	2	2	2	3	30%
Brazil*	2	2	3	3	25%
Costa Rica	3	2	2	3	25%
Panama	4	2	3	4	15%
Venezuela	2	3	3	4	20%

Rankings from 1 (low) to 5 (high) from GamblingLicenses.com

* Represents average of locations throughout the country.

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Intellectual Property Valuation Methods

Online Business Activities – Valuing Major Intangible Assets

HYPOTHETICAL EXAMPLE	---Projected---			
	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>Residual</u>
Brand/Domain Name of Made Up Company				
Total Casino Win	\$500	\$515	\$530	\$546
Royalty Rate: Brand/Domain Name @ 10%	50	52	53	55
Tax (@ 40% Tax Rate)	<u>20</u>	<u>21</u>	<u>21</u>	<u>22</u>
Cash Flow From Brand/Domain Name	\$30	\$31	\$32	\$33
Present Value Factor (@ 20% Discount Rate)	<u>.9129</u>	<u>.7607</u>	<u>.6339</u>	
Present Value Cash Flows	\$27	\$24	\$20	
Sum of the Present Value of Cash Flows	71			
Present Value of Residual Cash Flow (@ 3% growth rate)	<u>\$123</u>			
Present Value of Brand/Domain Name	194			
Present Value of Cash Flows Including the Tax Shield Benefit (@ 1.1582 if applicable)	\$225	(Value of Brand/Domain name = \$225)		

Source: No source, all numbers hypothetical & not reflective of industry or specific company or asset.





Intellectual Property Valuation Methods

Online Business Activities

□ **Valuing Major Intangible Assets**

➤ *Referral Agreements*

- Value using the Income Approach – Discounted Cash Flow Method

➤ *Exclusive Distribution Rights*

- Value using the Income Approach – Discounted Cash Flow Method



Context of Intellectual Property Valuations

1. Tax Uses:

- *Cross-Border Transfers of IP (Transfer Pricing – IRS Section 842)*
- *Cross-Border Payments for Use of IP*

2. Other Uses of IP Value

- *Contribution to Joint Venture*
- *Collateral*
- *Demonstration of Value to Potential Investors*



Context of Intellectual Property Valuations

Intercompany Pricing Analysis

□ Proposed Treasury Department Regulations (Reg # 1545-BA57)

- *Related party transfer pricing rules governing cost-sharing arrangements*
 - Change in tax treatment of cost of stock options when companies transfer intellectual property to subsidiaries abroad for cost-sharing purposes
 - Regulation requires participants in cost-sharing arrangements to share all costs related to the development of intangibles in the same proportion as they share the reasonably anticipated benefits attributable to the intangible development
 - Compensatory stock options should be taken into account in determining the cost of a participant
 - Regulation provides rules for measuring the cost associated with stock-based compensation
 - Taxpayers have a choice to measure the cost based on the stock price at the date of the exercise or the “fair value”, as noted in financial statements, at the date of grant

Information derived from “US Treasury Clamps Down on Export of Intellectual Property” by Mike Godfrey, Tax-News.com, New York, 30 July 2002; Press Release, Office of Public Affairs, 26 July 2002.



Context of Intellectual Property Valuations

Transfer Pricing Analysis

□ Treasury Department Regulations

➤ *Transfer of Intellectual Property*

- Benefits: deferral of the transfer of income to time that is tax efficient for the US company
- IRS has become more concerned about appropriate value being placed on transferred assets and that appropriate royalties are being paid to US parent
- These types of transactions have gained much attention from the IRS over the past year



Context of Intellectual Property Valuations

Establishing Value for Start-up Operations

- **Valuation of Start-up Operations Using Established Intellectual Property**

Value of Intellectual Property as used in the business

+ *Other assets contributed*

- *Costs to establish business*

+ *Benefits of "Business Plan" (which may be zero)*

= *Value of business*