

# INTANGIBLE ASSETS AS COLLATERAL

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*Federated Press, Toronto, Canada*

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Intangible Assets are a major item in every business but do not appear on the Balance Sheet unless acquired in a Business Combination. However in many cases they are protected by legislation (such items are commonly called Intellectual Properties) and can be used as collateral or in a sale and leaseback transaction.

## **Legal Aspects**

Before considering the various classes and types of Intangible Assets that can be used for borrowing, it is helpful to be aware of their legal position. Some protection dates back to antiquity. As early as 500 B.C., in the Greek colony of Syracuse, any cook who created a unique dish had exclusive rights to the profits from it for one year; "adaptations" were frowned upon and punished.

In the fourteenth century, European monarchs began granting temporary monopoly privileges to encourage local industry, such as the spinning of wool; this was done by a document called a "Letters Patent". As the printing press spread and fostered distribution of information throughout the Western world, under common law, judges with near feudal powers in England and France created the concept of "copyright", which, for a limited time, gave the author control of his work.

Intellectual Property law is based on two principles: fairness, and the public encouragement of creative intellectual endeavours. The first principle, which seems related to philosophy, has been disputed for many years; as one example, in declining the offer of a patent, Benjamin Franklin stated:

"As we enjoy great advantages from the inventions of others, we should be glad of an opportunity to serve others by the invention of ours, and this we should do freely and generously."

Alas, that lofty notion has been adhered to only rarely, one example being Banting and Best offering laboratory-created insulin to diabetics at no charge.

The second principle is based on the concept that both, economic incentives and certainty of financial return, are an integral part of creative activity. Since Intellectual Property rights are fundamental to competitiveness, it is argued that their protection promotes investment, transfer of technology and international trade.

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Therefore, for a specified period, depending on local statutes, the law gives inventors of new products or processes the right to control and profit from the exploitation of their ideas; it also protects those who use certain marks to distinguish their products or services.

While ideas often are the basis of commercial success, it may not always be possible to protect them as Intellectual Property. Examples include: scientific principles, mathematical theorems, surgical techniques, business methods, etc.; some patents have been granted in the US for the latter two. In another category, that of higher life forms, further conflict is likely over the next few years; for instance, the Harvard Mouse was patentable in the US, but not in Canada.

### **Patents**

In the late nineteenth century, patents created popular myths and heroes. Thomas Edison, who was granted over 1,000 in his lifetime for inventions such as the light bulb, the phonograph, even the movies, was a folk hero. Crowds mobbed his laboratory to see what he was doing. Speculators fought for control of his patents, giving rise to widespread criticism of Intellectual Property rights: that they protect the interests of those with the resources to pursue litigation over those of the individual inventor. Edison described a patent as nothing more than an "invitation to a law suit", stating with some exasperation:

"My electric light inventions have brought me no profits, only forty years of litigation."

However, he did not die a poor man.

#### *What is a Patent?*

Nevertheless, patents protect inventions. A patent gives the inventor of a new product or process the exclusive right to make and sell it in a particular country for a fixed period, usually twenty years. The monopoly period begins on the date the patent application is filed, but does not become enforceable until it is granted, usually two to three years later.

There are five categories of patents: art, process, machine, manufacture, and composition of matter. In general, they are granted to protect functions, such as the way parts of a machine or product interact (product patent), or the steps of a method (process patent). In the US, they also protect designs and, in the case of some pharmaceuticals, how the drug works in the body.

A patent application must be made in every country, or group of countries, in which protection is desired; it consists of two parts:

- The disclosure that describes how the product is made, or the best way to perform the process or method
- The claims which define the boundaries of the monopoly.

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Before issuing a patent, the applicable Patent Office compares the application with other known products and processes, often in the form of previously issued or rejected patents. During the review, the applicant may rework the application to properly reflect its innovative aspects.

### *The Role of Patents*

At the beginning of the third millennium, while Intellectual Property does not grip the public imagination in quite the same way as in Edison's time, something similar to the great patent conflicts of the late nineteenth century seems to be happening. The number of patents issued in the United States (over 150,000 a year between 1998 and 2002) is nearly double that of a decade ago. The European Union's Patent Office has a slower growth rate, partly due to the fact that it actively looks for objections and opposition before issuance.

Patents are not global, as they do not give protection outside the country of issue; however, if an idea has been patented in one country, in theory, only the same person can patent it in another. For example, only the person who holds the patent for, say, a "left-handed non-reciprocal screwdriver" in Italy can apply for a parallel patent in Brazil.

To satisfy growing demands from inventors for global patents, the world's patenting systems are slowly becoming more uniform by means of an international patent mechanism arranged by the United Nations' World Intellectual Property Organization, an affiliate of the World Trade Organization. This may prove difficult, because rules as to what is patentable vary from country to country.

For example, in the US, computer software and business processes can be patented; so can software in Canada, but neither is patentable in Europe. The law defining bio-technological composition of matter is broader in the US than in other developed countries; patents may be obtained not only on microorganisms and biological material, but also on plants and animals, like the Harvard Mouse previously mentioned. No such patents would be granted in Europe. In the US, applications have been made concerning genes, and patents are being issued not only for pharmaceuticals, but also for anti-bodies used in genetic testing and for modified agricultural products, such as canola.

More and more software-related patents, including those for business processes (as for instance by Alcoa), are being issued in the US, but, for two reasons, the process is becoming less relevant for high-tech firms than to industrial enterprises. First, technology changes so rapidly that a patent can easily be obsolete by the time it is granted; this normally implies that high costs have been incurred without much practical gain. Second, many young companies do not have the financial resources to apply for, maintain and protect patents, which require the disclosure of considerable, often highly significant information about the product. Therefore, most early-stage enterprises tend to rely on trade secrecy law instead of patents.

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### *Recent Trends*

The attitude that a patent was not an "incentive to creativity", but a "tool of monopoly" was prevalent from about 1890 to 1980. In that year the Supreme Court found in favour of several patent-holders in a contested case that previously would likely have been turned down. At the same time, Congress set up an appeals court to which all patent disputes were to be referred. This procedural reform, intended to clarify inconsistent decisions, had a dramatic effect. Up to then, around one in three patent-holders had won their cases; now two in three are successful. As a result, enterprises increasingly realize that among the few remaining barriers to entry are patents that grant twenty-year monopolies.

Dell understood this early. Manufacturing and testing required by its build-to-order system are complex, but without patents, others could copy it. By mid-2002, Dell had 77 patents protecting different parts of its processes, giving it a competitive edge.

Patents may be crucial to building a company's value. Bio-tech firms, which often make no profits for years, depend almost totally on their Intellectual Property. Other technology companies exploit their patents to increase earnings. IBM treated its patent portfolio as a means of defense until the 1990s, but then their strategy changed. Licensing has helped build the market for its know-how, and between 1994 and 1999, boosted such revenues by 200%, generating close to 20% of total profit. IBM obtains ten new patents throughout the world every business day.

Entities are no longer merely patenting goods they have already made; they are using patents to colonize new areas of technology. This is called "strategic patenting": things to be patented do not have to be completed by an inventor as long as he can plausibly describe how he plans to make it. Valuation analysts should make enquiries if a Reporting Unit's operating methods infringe on one of the numerous "business process" patents and take that possibility into account when establishing its Fair Value.

### **Copyrights**

A copyright provides legal protection for the form of the expression of an idea, but does not protect the idea itself. This applies to a wide range of manifestations, including paintings, drawings, sculptures, photographs, recordings, films and broadcasts as well as literary and musical works.

### *Registration*

Copyright arises automatically at the time the "original" work is created. Therefore, registration is not legally required but recommended, since it establishes ownership and simplifies litigation and recovery of damages. The statutory protection varies from country to country; in the US, the minimum is 25 years, with a maximum of 75 years after the creator's death. For works developed by a corporation through its employees, such as movies, the period is 95 years from the date of first public exposure. Under exceptional circumstances, it is even possible to copyright

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unpublished works after an individual's death; their statutory protection period starts with the date of registration.

The inclusion of computer programs into copyright statutes has transformed copyright law from an instrument used primarily for the protection of artistic endeavours, such as books, plays and music, to one that encourages commercial activities. In the US, there is some question if this extends to procedures, mathematical concepts, algorithms and methods of operation; this will eventually have to be sorted out by the courts. When valuing a copyright, as with a patent, it is imperative to seek specialized legal advice.

In most countries, copyright and industrial design filings are mutually exclusive; if a design qualifies to be registered as an industrial design, it is not protected by copyright. In the US, where patents can protect designs, they can also be covered by copyright.

### **Trademarks**

A trademark is a word, phrase, design, symbol, graphic or logo, which either alone, or in combination, is used to distinguish a person's or a company's product or service from that of others. It can be the brand name, but not the generic name of the product or service itself.

As well as trademarks, the statutes cover service marks that identify and distinguish the source of a service rather than a product. It also deals with collective marks that are used to identify goods or services produced by members of a group, and certification marks that verify the geographic origin or other characteristics of the goods or services. An example would be a vineyard in France shared by several producers.

#### *Registration*

When application is made for a registration, it must be demonstrated at that time that the proposed trademark is not confusingly similar to another actually in use. Once granted, a registration gives the owner the exclusive right to use that trademark in association with the specified goods and services for a period of fifteen years; this may be renewed repeatedly for further fifteen-year terms, as long as the use of the trademark continues. As a result, most trademarks have an indefinite life.

If a trademark is challenged, its distinctiveness is judged at the time when the lawsuit is filed. Throughout its life, including any renewals, the registration of a trademark is subject to being held invalid if it turns out not to have been distinctive at the time proceedings began. Common law rights in an unregistered trademark are generated by the owner through using it in association with his product or service, but such rights may be limited to the business or geographical areas in which it is known.

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Trademarks are specifically protected against both cyber-squatting and dilution - the weakening that can occur when someone avails himself of a famous trade name, even in a non-competitive way. For instance, dilution protection is how the national newspaper "The Sporting News" got a Federal Appeals Court to shut down a local gambling information service called "Las Vegas Sporting News". That case extended protection against dilution to trade names that are famous only in a niche market. Therefore, in valuing a trademark, it is essential to undertake an extensive search to discover if it inadvertently might be diluting the identifying mark of an organization that management has never heard of.

The courts have not yet decided if the Internet violates a trademark right by "using" a name, for instance, as a key to trigger a banner, as a meta-tag to help a search engine, or to link a browser frame to someone else's site without permission. As the Internet has a worldwide reach with about 200 different domains, there are many ways in which a trademark might be infringed upon. A useful book on US trademarks law, which is periodically updated, is "McCarthy on Trademarks and Unfair Competition".

### *Risk of Cancellation*

A major risk with trademarks and the brands they relate to is cancellation, if a court rules that consumers use the brand name to describe a generic category. This can result in the loss of a valuable corporate asset. Examples of brand names that have had their trademarks cancelled include: aspirin, brassiere, cellophane, cola, elevator, escalator, linoleum, monopoly, nylon, thermos, trampoline and yo-yo. Meanwhile, several brand names that are commonly used to refer to a general product category, such as Jeep, Lego, Kitty Litter, Kleenex, Rollerblade, Scotch, Sheetrock, Tarmac, Teflon and Xerox have been able to retain their protection.

Because of the complicated nature of the laws and regulations governing trademarks, in appraising one, a valuation analyst should enquire of counsel how the entity has attempted to defend itself against such risks; this is particularly important if any lawsuits have been filed to have a brand name declared generic, or if the brand has become dominant and its trademark a household word.

## **Other Intellectual Property**

### *Industrial Designs*

In the US, industrial designs can be protected by design patents, which have a twenty-year life. In most other countries, they fall under a separate category of Intellectual Property, known as a Registered Industrial Design; these protect the form of industrial products, such as their shape, pattern, or ornamentation. Unlike design patents, they do not protect any functional aspect of the design.

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In Canada, an industrial design registration is issued for five years and renewable for a second five year term. All products ornamented with or otherwise using a registered industrial design must bear proper markings to indicate they are protected.

### *Plant Breeders' Rights*

In the US, plants can be patented. This is not the case in most other countries, which, as an alternative, rely on Plant Breeders' Rights, a form of Intellectual Property that was established to protect new plant varieties, seeds and other propagating material, developed or modified by companies in the agri-science business. In order to identify and defend their creations, distinct rather than generic names are required for the goods. However, in some cases, due to the introduction of genetically modified material into their products, they, and thereby their trademarks, have become very controversial.

In many countries, the use of genetically modified material in food is discouraged, even prohibited, with further, far-reaching changes in attitudes and laws expected. FASB requires the establishment of the Fair Value of every Intangible Asset, which quite definitely includes rights to such products. The valuation analyst will find this extremely difficult, as any conclusion concerning such an Intangible Asset is sure to be subject to revision.

### *Integrated Circuit Typography Registration*

In the US, the Semiconductor Chip Protection Act of 1984, part of the Copyright Act, prevents unauthorized reproduction and distribution of computer chips. This Intellectual Property right is very important, since a new family of semiconductor integrated circuit designs can cost several hundred million dollars to develop, and a further billion to build the sophisticated plant necessary to produce it. In other countries, the design of a computer chip can be protected through an integrated circuit typography registration, which covers the three-dimensional configuration of the electronic circuits embodied in integrated circuit products or layout designs.

## **Trade Secrets**

Trade secrets are data, or "know how", collected or created by an entity or individual for private commercial use. One definition is information, including formulas, patterns, compilations, programs, devices, methods, techniques, or processes that:

- Reap independent economic value, actual or potential, from not being generally known; and
- Are the subjects of efforts, reasonable under the circumstances to maintain secrecy?

Trade secret are recognized as Intangible Assets only when one criterion is met, which is likely to be the case when laws or regulations protect future economic benefits; they include all confidential, commercially valuable information. Trade secrecy law applies to any person who has acquired confidential information from its owner, no matter by what means.

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In many ways, trade secrets are the most important manifestation of Intellectual Property, yet, as their owners usually only have common law to rely on, they are the least protected. Very few countries have followed the US, where in some States trade secrets are protected by the Uniform Trade Secrets Act. This codifies common law, which is important in the valuation of an entity's core technology; it frequently consists of a mixture of patents, copyrights, licenses and trade secrets.

### **Classes and Types of Intangible Assets**

The determination of whether or not a specific acquired intangible is an Intangible Asset must be based on the facts and circumstances of each individual Business Combination.

Sections 1581, A18 to A38 of the Canadian Institute of Chartered Accountants ("CICA") Handbook sets out examples of assets that meet the criteria, divided into five categories, according to what they relate to: Marketing, Customer, Artistic, Contract and Technology. To those, we find it useful to add a sixth, Governmental, covering licenses of all sorts which the CICA includes with Contracts. After each item, is indicated: (C) it can sometimes be used as collateral.

### **Marketing**

- Trademarks, trade names (C) - Words, names, symbols, or other devices used to indicate the source of the product and distinguish it from the products of others
- Service marks, collective marks, certification marks - All of those may be protected legally through registration with government agencies or continuous use in commerce
- Trade dress (unique colour, shape or package design)
- Newspaper or magazine mastheads (C) - A masthead, such as the New York Times, is a trade name with a copyrighted tagline, "All the News that's Fit to Print"
- Internet domain names - These are unique alphanumeric symbols used to identify particular Internet addresses. For a period, registration of a domain name associates it with a designated computer host on the Internet. The largest registrar of domain names in the world is subject to Virginia State Law. In 2000, the Virginia Supreme Court ruled that a domain name is not a property, only a contract right; it can therefore not be garnisheed, nor become subject to a lien or security agreement, but it may be sold
- Non-competition agreements.

The terms "brand" and "brand name" are often used as synonyms for trademark and trade name. However, the former are general marketing terms that typically refer to a group of complementary assets, such as a trademark and its related trade name, trade dress, formulas, recipes and technological expertise, all of which may or may not be legally protected. A formula sets out the ingredients, while a recipe also describes the process. An enterprise may recognize, as a single

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Intangible Asset, a group of related intangibles commonly referred to as a brand, if the items making it up have similar useful lives.

### **Customer**

- Customer lists (C) - These consist of information about buyers of a product or service, such as names and contact information; it may also be in the form of a database that includes other particulars, as for instance order histories and demographics. Those do not relate to any contractual or other legal rights, but are valuable and frequently leased or exchanged. For that reason, they are Intangible Assets; however, they are not if the terms of confidentiality or other agreements prohibit an enterprise from selling, leasing, or otherwise exchanging information about its customers
- Order or production backlog (C) - If this comes from contracts, such as purchase orders, the backlog is an Intangible Asset, even if the purchase orders are cancellable
- Customer contracts and related relationships (C) - A relationship exists between an entity and its customers, if:
  - The entity has information about the customer and has regular contact with the customer; and
  - The customer has the ability to make direct contact with the entity. Relationships may arise from contracts (such as supplier contracts and service contracts). However, customer relationships may arise through means other than contracts, such as through regular contact by sales or service representatives.

When an enterprise establishes relationships with its customers as a result of regular contact and the customer is able to deal directly with the enterprise, the customer relationship becomes a contractual right. Those customer contracts and relationships are Intangible Assets, even when confidentiality or other contractual terms prohibit their sale or transfer.

- Non-contractual customer relationships - If a customer relationship does not arise from a contract, but can be transferred together with some other asset or liability, it is also an Intangible Asset. An example is a bank's relationship with its customers, which may be transferred together with the deposits or loans, and therefore is an Intangible Asset.

The term "customer base" applies to a group of customers not known or identifiable to the company, for instance, patrons of a fast-food franchise or a movie theatre. This differs from a "customer list", which refers to known purchasers. Therefore, as it is not separable, a customer base is not an Intangible Asset.

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### **Artistic**

- Plays, operas, ballets, etc.
- Books, magazines, newspapers, literary works (C)
- Musical works, such as compositions, lyrics, jingles (C)
- Pictures, photographs (C)
- Video and audio-visual material, including motion pictures, music videos and television programs (C)

These artistic items are Intangible Assets when they are copyrighted and may be transferred, either in whole, through assignments, or in part, through licensing agreements.

Copyrights in turn give rise to subsidiary rights. For a work of fiction, these can include: paperback editions, translations into foreign tongues, and dramatic, film or television adaptations. The Fair Value of a copyright involves consideration of all outstanding assignments or licenses.

### **Contract**

- Licenses, royalties, standstill agreements (C)
- Advertising, construction, management, service or supply agreements
- Leases (C)
- Construction permits
- Franchises (C)
- Rights to broadcast programs; use of certain operating equipment (C)
- User rights, such as drilling, water, air, mineral, route authorities and timber cutting (C)
- Servicing rights, such as for mortgages (C)
- Employment contracts.

Leases are the most common contract-based Intangible Asset. Under GAAP, capital leases for physical assets, such as office equipment, are treated as purchase contracts by the user, with the leased items being capitalized and the future payments, less imputed interest, recorded as a liability. This is not applied to operating leases, although such contracts, if long term, may have considerable value. In some cases, the Fair Value of a lease can be negative.

Servicing contracts for financial assets are another type of contract-based Intangible Asset. Servicing, which is an inherent component of the ownership of any financial asset, becomes a distinct item only:

- When it is contractually separated from the underlying assets by their sale or securitization, with separate servicing rights; or
- Through the separate purchase and assumption of the servicing. When mortgage loans, credit card receivables, or other financial assets are part of a Business Combination and the

## **Intangible Assets as Collateral**

Acquirer retains the servicing component, the inherent servicing rights are not considered an Intangible Asset; their Fair Value is included in that of the acquired financial assets.

However, an acquired servicing right is an Intangible Asset. This is a contract to service financial assets, under which estimated future revenues from servicing fees, late charges and ancillary items are expected to more than adequately compensate the service provider for performing the activity. A servicing contract is either:

- Undertaken in conjunction with selling or securitizing the financial assets being serviced; or
- Purchased or assumed separately.

Some contracts stipulate payments that are higher than the current market rate for the product or service; they are considered unfavourable and therefore give rise to a liability of the present value of the future excess payments. In such circumstances, the related liability must be recognized immediately on the consolidated Financial Statements. Another example is a contract that includes a "take-or-pay" provision, as for instance a natural gas purchase agreement requiring a firm to buy amounts that exceed its current consumption.

### **Technology**

- Patents (C)
- Computer software, display formats and mask works (C)
- Non-patented technology
- Databases (C)
- Trade secrets, such as proprietary formulae, processes, recipes, etc.

Technology-based Intangible Assets relate to innovations or technological advances. In many cases, their future economic benefits are protected through legal or contractual rights.

Computer software and display formats, which are legally protected by patent or copyright, meet the contractual/legal criterion. Even if this is not the case, if the software and display formats can be separated from the acquired business (either individually or as a combination) and sold, transferred, licensed, rented, or exchanged, then they are considered to be Intangible Assets.

Mask works consists of software permanently placed on a read-only memory chip as a series of stencils or integrated circuits. In the US, mask works qualify for protection under the Semiconductor Chip Protection Act. Acquired mask works protected under that Act or other similar laws or regulations meet the contractual/legal criterion; otherwise they are separable.

Databases are collections of information, often stored in electronic form, such as on computer disks or files. An acquired database that includes original works of authorship is entitled to

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copyright protection. However, a database often includes information created as a result of an enterprise's normal operations, such as a customer list, a title plant, scientific data, or credit information. While they may not be protected by copyright, they can be (and often are) transferred, exchanged, licensed or leased to others in part or in their entirety; as such, a database normally is an Intangible Asset.

### **Governmental**

This category includes the myriad of licenses and permits issued by Federal, Provincial and local governments; an example of each is:

- Broadcast Licenses (C) - Federal
- Trucking Licenses - Provincial
- Taxi Medallions (C) - Local

### **Other Intangibles**

#### *Assembled Workforce*

The CICA specifically excluded an assembled workforce of "at will" employees (those not subject to contractual employment agreements) acquired in a Business Combination from being an Intangible Asset. Employees subject to a collective bargaining agreement (union contract) are considered an at will work force. However, the collective bargaining agreement itself may be an Intangible Asset. Depending on its terms, a union contract could either have a positive or more likely a negative value. Therefore, they should be valued in the same manner as other agreements, with their Fair Value depending on employment costs relative to the market, may be difficult.

#### *In-Process Research & Development*

Anything obtained in a Business Combination, In-Process Research & Development ("IPR&D") is immediately expensed. Therefore, all amounts assigned to physical and Intangible Assets that relate to a particular R&D project and have no alternative future use are written off on closing.

It is a matter of judgement as to how much of the cost of a new product, in Beta testing at the acquisition date, that becomes commercial before the completion of the Purchase Price Allocation, should be considered IPR&D, and how much is a severable Intangible Asset; in our view, at that stage, very little is IPR&D.

#### *Industry-Specific Items*

The determination of whether or not a specific acquired intangible is an Intangible Asset should be based on the facts and circumstances, taking into account the practices of the industry; even after some years of experience, the classifications of many industry-specific intangibles are not yet definitively established.

## **Intangible Assets as Collateral**

Some of those, which may be used as supplemental collateral are:

Industry	<ul style="list-style-type: none"><li>• Intangible Asset</li></ul>
Banking	<ul style="list-style-type: none"><li>• Core deposits</li><li>• Trust relationships</li></ul>
Distribution	<ul style="list-style-type: none"><li>• Distribution agreements</li><li>• Sales agency agreements</li><li>• Supply contracts</li></ul>
Health Care	<ul style="list-style-type: none"><li>• Operating licenses</li><li>• Pharmaceutical trial contracts</li></ul>
Investment	<ul style="list-style-type: none"><li>• Investment management contracts</li></ul>
Manufacturing	<ul style="list-style-type: none"><li>• Customer Relationship Management systems (leasebacks)</li><li>• Enterprise Resource Planning systems (leasebacks)</li></ul>
Media	<ul style="list-style-type: none"><li>• Advertising contracts</li><li>• Network affiliation agreements</li></ul>
Natural Resources	<ul style="list-style-type: none"><li>• Cutting rights</li><li>• Easements</li><li>• Leases</li><li>• Licenses and permits</li><li>• Mineral rights</li><li>• Mining claims</li><li>• Seismic data</li></ul>
Real Estate	<ul style="list-style-type: none"><li>• Unclosed sales</li><li>• Property management contracts</li></ul>
Telecommunications	<ul style="list-style-type: none"><li>• Frequency allocations</li><li>• Licences</li></ul>

### **Lenders Positions**

Lenders on Intangible Assets are not only concerned with the saleability of the intangible but more importantly with the Cash Flow which it generates.

For example in the case of a leveraged buyout of a Canadian distiller some years ago the bank would only lend 40% of the cost of the whisky inventory due to the evaporation losses during the several years of maturation. However when the trade name was grouped with the inventories the loan to value ratio increased to 70% as the ability to sell the product was enormously increased.

## Intangible Assets as Collateral

### Values for Collateral

In preparing valuations for lenders, it is important to consider several scenarios as to the future activities of the business. In a recent case when a Canadian firm borrowed from a US bank against its Receivables and Inventory and Intangible Assets as well as its future Cash Flows we prepared the "Estimates of Fair Market Value". The balance of this paper deals with the valuation of the two major items, Core Technologies and the Tradename.

#### *Core Technologies*

To value the Core Technologies, CVS looked at the revenues generated by the products derived from them and applied the relief from royalties method. This involves estimating the royalties that would have to be paid for to use it. To obtain the appropriate rate, we searched the Royalty Stat LLC's database for SIC codes 357 (Electronic Computer), 323 (Communications Equipment) and 737 (Computer Programming). Twenty agreements for technologies licenses were found; the reported royalties were:

<b>Rate</b>	<b>Number</b>	
%		
1.0	1	Mean 9.1%
2.0	2	Median 5.0%
3.0	1	Standard Deviation 9.1%
5.0	10	
10.0	3	
20.0	1	
30.0	1	
35.0	<u>1</u>	
.	<u>20</u>	

Although the median would normally be selected, we chose 4% (the weighted average of the rates from 1% to 5%) as those for 10% and up relate to software. This is the same rate as for the valuation we prepared for a reorganization of the client's European subsidiaries in June 2003; at that time it was based on recent transactions from the Chairman of a trademark consulting firm in La Jolla, CA.

The after tax amounts based on expected sales have been discounted over the 30 months of the Core Technologies' remaining useful life as shown in the table below:

## Intangible Assets as Collateral

\$'000		2004	2005	2006	2007
		Q4			Q1
Sales		<u>10,455</u>	<u>45,000</u>	<u>48,600</u>	<u>12,900</u>
Royalty	4%	418.2	1,800.0	1,944.0	516.0
less tax	36%	<u>(150.6)</u>	<u>(648.0)</u>	<u>(699.8)</u>	<u>(185.8)</u>
Net		<u>267.6</u>	<u>1,152.0</u>	<u>1,244.2</u>	<u>330.2</u>
PV Factor	25%	0.9412	0.7529	0.6024	0.5669
Present Value		<u>251.9</u>	<u>867.3</u>	<u>749.5</u>	<u>187.2</u>
Total Present Values		2,056.0			

The total of the Present Values is \$2,055,000, which we rounded to \$2,050,000. If sales are 3% less in 2004, 5% in 2005 and 10% thereafter the Fair Market Value becomes \$1,910,000 - 7% less.

### Brand Name

The principle product is the worldwide leader in market share of its category. With respect to the brand name, there were eight agreements for trademarks in the same SIC codes with the following characteristics:

Rate	Number	
%		
1.0	2	Mean 12.1%
5.0	2	Median 8.5%
12.0	1	Standard Deviation 11.8%
13.0	1	
30.0	2	
.	8	

Excluding the 30% rates that apply to software, the mean is 6.2%, and the median 5.0%. We applied the latter to the projected revenues of both the current product sold under the trade name and the planned two further generations (the first of which was under development) until the end of 2011.

Annual growth after 2007 is assumed to be 6% in 2008, 5% in 2009, 4% in 2010 and 3% in 2011. These give \$5,233,000 for the trade name as follows:

## Intangible Assets as Collateral

	<b>Grow th</b>	<b>Revenue</b>	<b>Royalty</b>	<b>Tax</b>	<b>Net</b>	<b>PV Factor</b>	<b>Present Value</b>
			5%	36%	25%		
2004 Q4		10,455.00	522.70	(188.20)	334.50	0.94	315.00
2005	7.60%	45,000.00	2,250.00	(810.00)	1,440.00	0.75	1,084.00
2006	8.00%	48,600.00	2,430.00	(874.80)	1,555.20	0.60	937.00
2007	6.20%	51,600.00	2,580.00	(928.80)	1,651.20	0.48	796.00
2008	6.00%	54,700.00	2,735.00	(984.60)	1,750.40	0.39	675.00
2009	5.00%	57,400.00	2,870.00	(1,033.20)	1,836.80	0.31	566.00
2010	4.00%	59,700.00	2,985.00	(1,074.60)	1,910.40	0.25	471.00
2011	3.00%	61,500.00	3,075.00	(1,107.00)	1,968.00	0.20	388.00
							<u>5,233.00</u>

## Resulting Loan

On the following assets the bank lent \$8 million.

	<b>\$'000</b>			<b>Liquidation Value</b>
	<b>Book Value</b>	<b>Fair Value</b>	<b>Recovery</b>	
Receivable mainly	3,928	3,928	70%	2,750
Inventories in Canada	<u>2,633</u>	<u>2,633</u>	50%	<u>1,317</u>
	6,561	6,561		4,066
Equipment – net	<u>1,123</u>	<u>1,123</u>	25%	<u>281</u>
	7,684	7,684		4,347
Intangible Assets	1,951	2,050	50%	1,025
Goodwill	<u>2,855</u>	<u>5,250</u>	50%	<u>2,625</u>
	<u>12,490</u>	<u>14,984</u>		<u>7,997</u>

The Loan ratios were:

	<b>%</b>	
Receivables	70	2,750
Inventories	50	<u>1,316</u>
		4,066
Equipment	25	284
Intangibles	50	<u>3,650</u>
		<u>8,000</u>