

BORROWING AGAINST INTANGIBLE ASSETS



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Classes And Types Of Intangible Assets



- Actual Intangible Assets depend on the facts and circumstances of the individual situation
- Sections 1581 A18 to A38 of the Canadian Institute of Chartered Accountants ("CICA") Handbook sets out examples of assets that meet the accounting criteria

Classes And Types Of Intangible Assets



- Divided into five categories according to what they relate to:
 - Marketing
 - Customer
 - Artistic
 - Contract
 - Technology

Classes And Types Of Intangible Assets



- We find it useful to add a sixth
 - Governmental
- This covers licenses of all sorts which the CICA includes with Contracts
- When (C) is indicated after an item 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

Marketing



- Service marks, collective marks, certification marks
- May be protected legally through registration with government agencies or by continuous use in commerce

Marketing



- Trade dress (unique colour, shape or package design)
- Newspaper or magazine mastheads (C)
 - The Globe and Mail is a trade name with a copyrighted tagline “Canada’s National Newspaper”

Marketing



- Internet domain names are unique alphanumeric symbols to identify particular Internet addresses
- For a period, the domain name registration associates it with a designated host on the Internet

Marketing



- The largest registrar of domain names in the world is subject to Virginia State Law
- In 2000 the State Supreme Court ruled that a domain name is
 - not a property, only a contract right
 - cannot be garnisheed
 - is not subject to a lien or security agreement
 - but may be sold

Marketing



- “Brand” and “Brand Name” are not synonyms for trademark and trade name
- They are general terms referring to a group of complementary assets such as:
- A trademark and its trade name, trade dress, formulas, recipes and technological expertise

Customer



- Customer lists (C) providing information about buyers of a product or service
 - Simple format of names and contact information do not relate to contractual or other legal rights but is valuable and frequently leased or exchanged

Customer



- Customer contracts and related relationships (C)
 - relationships exists between an entity and its customers if:
 - ✦ the entity has information about the customer and regular contact through sales or service representatives
 - ✦ the customer has the ability to make direct contact with the entity

Customer



- **Non-contractual customer relationships**
 - if a customer relationship arises not from a contract but can be transferred together with some other asset or liability it is an Intangible Asset
 - example – a bank's relationship with its customers may be transferred with the deposits or loans therefore is an Intangible Asset

Customer



- “Customer list” refers to known purchasers
- “Customer base” applies to a group of customers not known or identifiable, i.e. patrons of a fast-food franchise or a movie theatre
- As it is not separable it is not an Intangible Asset

Customer



- Order or production backlog (C)
 - If from contracts, such as purchase orders, the backlog is an Intangible Asset even if the purchase orders are cancellable

Artistic



- Plays, operas, ballets, (C)
- 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)

Artistic



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

Artistic



- Copyrights give rise to subsidiary rights
- A work of fiction will include paperback editions, translations, dramatic adaptations, etc.
- 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)

Contract



- Leases are the most common contract-based Intangible Asset
- Under GAAP capital leases for physical assets are treated as purchase contracts
- Leased items are capitalized and future payments less imputed interest recorded as a liability

Contract



- This is not applied to operating leases although, if long term, they may have considerable value
- In some cases when the real estate market drops, the Fair Value of a lease can be negative

Technology



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

Technology



- Technology-based Intangible Assets relate to innovations or technological advances
- Their future economic benefits are protected through legal or contractual rights

Technology



- Computer software and display formats can be legally protected by patent or copyright and meet the contractual or legal criterion

Technology



- Even if not copyrighted the software and display formats can be separated from the acquired business (individually or as a combination) and sold, transferred, licensed, rented, or exchanged
- Then they are considered Intangible Assets

Databases



- Databases are collections of information often stored in electronic form
- An acquired database including original works of authorship is entitled to copyright protection

Databases



- A database often includes information as a result of an enterprise's normal operations such as
 - customer list
 - title plant
 - scientific data
 - credit information

Databases



- They may not be protected by copyright but can be (and often are) transferred, exchanged, licensed or leased to others in part or in their entirety
- Therefore a database normally is an Intangible Asset

Governmental



- Governmental includes the myriad of licenses and permits issued by Federal, Provincial and local governments:
 - Broadcast Licenses (C) - Federal
 - Trucking Licenses (C) - Provincial
 - Taxi Medallions (C) - Local

Values for Collateral



- Lenders on Intangible Assets are concerned with
 - the saleability of the intangiblemore importantly
 - the Cash Flow it generates

Values for Collateral



- In the case of a leveraged buyout of a Canadian distiller some years ago the bank involved would only lend 40% of the cost of the whisky inventory due to the evaporation losses during the several years of maturation

Values for Collateral



- But 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

Values for Collateral



- In preparing valuations for lenders it is important to consider several scenarios as to the future activities of the business

Values for Collateral



- In June 2008, my firm with a US partner, prepared the relevant "Estimates of Fair Market Value" as at 31 March 2008 which enabled a Vancouver electronics firm to borrow from a US bank

Values for Collateral



- The balance of this presentation deals with the basics of the valuations of the two major Intangible Assets used with receivables, inventory and equipment as collateral
 - Core Technologies
 - Trade Name

Core Technologies



- The Core Technology included two hardware patents expiring 13 May 2016 & 17 March 2017 and a number of items of copyrighted software
- For the valuation CVS looked at the revenues generated by the products derived from it and applied the relief from royalties method

Core Technologies



- This involves estimating the royalties
- For the appropriate rate we searched Royalty Stat LLC's database SIC codes
 - 357 - Electronic Computer
 - 323 - Communications Equipment
 - 737 - Computer Programming

Core Technologies



- There were twenty agreements for technologies licenses with reported royalties:

<u>Rate</u>	<u>Number</u>	
%		
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	1	

Core Technologies



- Although the median would normally be selected we chose 4% (the weighted average of the rates from 1% to 5%)
- Those for 10% and up relate solely to software

Core Technologies



- The same rate was used in the valuation we had previously prepared for a reorganization of the client's European subsidiaries
- It was based on information of recent transactions

Core Technologies



- After tax amounts based on expected sales were discounted at 25% over the conservatively assumed 30 months of the Core Technologies' remaining useful life:

Core Technologies



		\$'000		
		2008	2009	2010
Period		<u>9 mos</u>	<u>12 mos</u>	<u>9 mos</u>
Revenues		31,365	38,700	29,625
Change			-7.5%	2.1%
Royalty	4.0%	1,255	1,548	1,185
Tax Rate	BC	31.5%	30.0%	29.0%
Income Tax		(395)	(464)	(344)
Net		859	1,084	841
PV Factor	25%	0.9143	0.7314	0.5851
Present Value		786	793	492
				<u><u>2,071</u></u>

- Total Present Values \$2,071,000 rounded to \$2,100,000

Trade Name



- The firm's principle product is the worldwide leader in market share of its category
- For the trade name we looked at eight agreements for trademarks in the same SIC codes with the following characteristics

Trade Name



<u>Rate %</u>	<u>Number</u>	
1.0	2	Mean 12.1%
5.0	2	Median 8.5%
12.0	1	Standard Deviation 11.8%
13.0	1	
30.0	<u>2</u>	
	<u>8</u>	

Trade Name



- Excluding the 30% rates that apply to software, the mean is 6.2%, and the median 5.0%
- We applied the latter to projected revenues of the current product sold under the trade name and the two planned next generations (the first now under development) to the end of 2015

Trade Name



- Annual growth is assumed to be
 - 3.5% in 2011
 - 3.4% in 2012
 - 4.0% in 2013
 - 3.0% in 2014
 - 2.0% in 2015

Trade Name



- Gives \$5,250,000 (rounded) for the trade name

Year	Growth	Revenue	Royalty 5.0%	Tax Rate BC	Income Tax	Net	PV Factor 25%	\$'000 Present Value
2008		31,365	1,568	31.5%	(494)	1,074	0.9143	982
2009	-7.5%	38,700	1,935	30.0%	(581)	1,355	0.7314	991
2010	2.1%	39,500	1,975	29.0%	(573)	1,402	0.5851	821
2011	3.5%	40,900	2,045	27.5%	(562)	1,483	0.4681	694
2012	3.4%	42,300	2,115	27.5%	(582)	1,533	0.3745	574
2013	4.0%	44,000	2,200	27.5%	(605)	1,595	0.2996	478
2014	3.0%	45,300	2,265	27.5%	(623)	1,642	0.2397	394
2015	2.0%	46,200	2,310	27.5%	(635)	1,675	0.1917	<u>321</u>
								<u><u>5,254</u></u>

Resulting Loan



- On the following assets the bank lent \$10 million

	Book Value	Fair Value	Lending Ratio	\$'000 Collateral Value
Receivables	8,285		70%	5,800
Inventory	2,630		50%	1,315
Equipment, jigs etc	1,511		60%	907
Technology		2,100	25%	525
Trademark		5,250	30%	1,575
				<u>10,121</u>

It Can Be Done



- On 7 March 2009 the Globe and Mail reported that “Annie Leibovitz, a photographer, recently borrowed \$15 million (US) against her entire collection of images.”
- The loan was from Art Capital of New York and her copyrights were the principal collateral