Intellectual Property Valuation and Due Diligence in Mergers and Acquisitions – Some Practical Insights

A critical component of a target company's valuation in mergers and acquisition is the overall worth of the intangible assets associated with the company, uniquely developed, acquired or operated for its product or service offerings or derived from it. Broadly, these include the company's trademarks, patents, copyrights, trade secrets, industrial designs; and by extension, the value of the market recognition or goodwill connected with the company's use of the intellectual property (IP).

For technology businesses, where innovation forms the critical asset for revenue generation and market competitiveness, IP valuation assumes a significantly more central position in the deal evaluation from both the acquirer and acquiring company's perspectives. For the acquirer, integrating an existing company's valuable IPs into their portfolio facilitates seamless market entry and this confers a major strategic advantage in the dynamic technology industry where time to market is critical for market positioning. The acquisition of a technology with tested market potential can accelerate growth, expand market share more rapidly and steer research and development efforts on a steady course for future innovative product offerings.

Typically, the acquirer focuses on a wide variety of matters concerning the intrinsic value of the IP, the nature and extent of the legal right vested in the target company and its transferability, the risks connected with the operation and commercialization of the IP, the existing and contingent liabilities, the market potential, and prospects of further developing the acquired IP. From the seller's perspective, the objective is to strategically demonstrate the value and potential of the IP. This is a key aspect in assessing the overall valuation of the company in M&A negotiation.

Using these asset-based metrics to enhance valuation in the M&A process is much-more complex and uncertain when intangibles are in question. It involves an extensive range of variables such as utility, degree of available legal protection, risks, lifespan, market potential, competitiveness, profit potential and the extent to which future innovations are possible – enabling the business to stay competitive as newer technologies emerge in the market.

Valuing Intellectual Property – Common Approaches

Three methods are conventionally adopted in determining the value of IP. The choice of a method essentially depends on the nature of the IP asset, the industry and the purpose or context of the valuation[1], for example[2] whether valuation is undertaken for sale or purchase, M&A, joint ventures, spin-off, licensing, franchising or for the purpose of computation of damages as in the context of IP enforcement. However, a combination of these methods provides wider parameters for analysing the proprietary value of the IP asset. We highlight the three common techniques for valuing IP assets as follows:

---

[1] Sharma, Dilip, and Abhijeet Kumar, 'Methods for Intellectual Property Valuation', in Irene Calboli, and Maria Lillà Montagnani (eds), Handbook of Intellectual Property Research: Lenses, Methods, and Perspectives (Oxford, 2021; online edn, Oxford Academic, 23 Sept. 2021), https://doi.org/10.1093/oso/9780198826743.003.0039, accessed 5 Feb. 2024.

[2] A. Damodaran, IP and Finance: Accounting and Valuation of IP Assets and IP Based Financing, WIPO, https://www.wipo.int/export/sites/www/sme/en/documents/pdf/ip_panorama_11_learning_points.pdf accessed 5 Feb. 2024.

Cost-based Valuation:

This involves determining the value of an IP asset by assessing the cost of creating a similar asset at a specific point in time. This approach is utilized to establish the baseline value and cost associated with the IP asset. Two distinct methods are employed in this process. The first is the reproduction cost method, which concentrates on the expense of replicating the relevant IP assets while maintaining current quality and standards. The second method, replacement cost, assesses the value based on the cost of creating a comparable IP asset with similar use or functionality.

Market-based Valuation:

This centres on comparing the pricing of similar IP assets in comparable transactions. This process involves sourcing information on the relevant market and comparable IP transactions, ensuring that the information genuinely reflects arm's length considerations, and defining the appropriate unit for comparison, among other factors.

Income-based Valuation:

It considers the economic value and revenue-generating potentials of the IP in determining its overall worth. In this context, the historical cash flow information then provides a suitable basis for estimating future earnings value more accurately.

Key Aspects of IP Due Diligence in M&A and Insights for Technology Companies Anticipating Consolidation.

Businesses involved in the acquisition of technology companies must approach the due diligence process with a strategic lens, adopting wider evaluative metrics that extend beyond legal and financial considerations or risks. The due diligence process should act as an x-ray, not only for assessing the value, risks, and liabilities but also for evaluating potential synergies arising from the acquisition and providing critical information required to maximize them.

In this sense, IP due diligence provides an informed basis for M&A pricing, negotiation, risk allocation and post-completion integration because it provides clarity on legal and commercial risks, existing or potential liabilities and strategic benefits that may be obtained from acquiring the IP in view of the broader goals for the consolidation.

Businesses involved in the acquisition of technology companies must approach the due diligence process with a strategic lens, adopting wider evaluative metrics that extend beyond legal and financial considerations or risks.

Technology companies anticipating a change of control must take seriously the issue of internal management of IP assets and proactively prepare for IP valuation and due diligence to get the very best of their IP assets. We highlight a few practical action steps:

- Identify your core IP assets and apply to register all IP rights that require registration to be legally protected (for example, trademarks, patents and designs). Registration also signals the strength of your IP rights in a potential acquisition,

- Keep a comprehensive record of all IP assets, including patents, trademarks, copyrights, development processes, and any licensing agreements,

- Conduct regular internal IP audits to assess the status, strength, and potential risks associated with intellectual property. Identify any gaps, potential infringements, or issues that need to be addressed,

- Ensure that employment and contractor agreements clearly define the ownership and confidentiality of intellectual property created during the course of employment or engagement. Ensure that all ownership rights are properly transferred or licensed,

- Routinely conduct a comprehensive risk assessment in connection with your IP portfolio. Actively monitor ongoing or threatened litigation or third-party claims that might impact the validity or valuation,

- Evaluate the market potential of your intellectual property. Understand its current and future relevance in the light of new technologies; and

- Develop an effective communication channel for addressing IP-related concerns during the due diligence process; ensuring prompt and rapid response to information requests.

Concluding Remark:

A comprehensive assessment of the legal, financial, and operational aspects of the IP portfolio is important to both the Target Company and the acquiring company engaged in a change of control transaction. Due diligence outcomes impact valuation as more information emerge that help to determine the inherent proprietary value, risks, and liabilities connected with the IP assets and its future commercialization and development. Leveraging the findings from due diligence, it becomes possible to define the scope of warranties and indemnities more appropriately and optimize the synergies achievable from acquiring the target company's IP assets.

Authors

Abimbola Ojenike
E: abimbola@slingstonelaw.com

Tosin Atanranshe
E: tosin@slingstonelaw.com

Phone : +2348027752339
Email: info@slingstonelaw.com

22, Dr. Omon Ebhomenye Street
off Admiralty Way, Lekki I,
Lagos.
Nigeria
@slingstonelaw