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Intellectual Property

Valuing Intellectual Property in Distressed Situations: Brand Appraisals

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As the secured lending market becomes more competitive and more lenders stretch down the balance sheet, assets traditionally considered "boot collateral" are being included in asset-based formulas, or at the very least, being valued more specifically. While liquidation appraisals for inventory and other hard assets have been the foundation of asset-based lending for decades, only recently has it become commonplace for lenders to require a brand appraisal to back stretch or junior loans.

Conventional brand and enterprise evaluations have been used for decades as well to establish a benchmark price for a sale or accounting purposes. Typically, these assessments do an excellent job of estimating brand value in healthy businesses. Brands are assumed to be part of an on-going enterprise where any sale would likely be to a strategic buyer. While helpful, these assumptions, methodologies and processes are not what a lender needs to back a secured loan.

Bankable hard-asset (inventory, real estate, equipment, etc.) appraisals used by asset-based lenders project net order liquidation values based on the disposition experience of liquidators. The assumptions reflect real-world liquidation experience, relying heavily on field assessments of the current asset's composition and selling environment.

Similarly, a brand appraisal should reflect the net orderly liquidation of the brand, and only the brand, in a distressed sale environment to a liquid market of financial buyers. While a strategic buyer may, in fact, rise to the occasion and purchase the brand during a court-authorized liquidation of a company, unless there is guaranteed to be numerous strategic buyers bidding for the brand, the inherent liquid market value is determined by competing financial buyers.

In cases where the entire enterprise is not sold off, the assets of the company are bid on in open court by liquidators. Inventory, real estate, accounts receivable, equipment and intellectual property are typically sold off individually. While there are cases where one or more of these assets may be packaged together, the lender needs to know the value that each piece of collateral –tangible and intangible—will bring in liquidation.

Here at Gordon Brothers, we have been appraising assets for over a decade and liquidating assets for over a century. Appraisals have always been reflective of real-world disposition experience and the bankruptcy court process. Senior and junior secured lenders alike have engaged GB Asset Advisors, LLC (GBAA) to appraise the collateral of their clients to accurately establish value and risk. While appraising brands presents unique challenges (as discussed below), the underlying assumption of a court-authorized sale is crucial for the lender to make financing decisions.

Once again, as with the sale of hard-assets, circumstances within a sale environment have a profound affect on brand values. As the brand is stripped away from related assets (e.g., inventory) and is temporarily tainted due to the uncertainty caused by the bankruptcy, there is inevitably sales disruption to the customer base. On the other hand, a sale of the brand to a new buyer may remove restrictions, contractual or managerial, that will allow the brand to increase in value. These considerations need to be taken into account when valuing the brand.

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Assuming the brand represents a consumer product, assessing how the branded inventory and competitors' inventory are positioned in the market place and at key customers is crucial. Brand appraisals are often done in conjunction with inventory appraisals as the merchant's perspective is one of three key components to the inventory process in both cases. This field due diligence is compared with an extensive database of brand values and licensing rates and combined with the analysis of the projected brand's performance. At GBAA, these three pieces come together and are presented for "sign-off" to principals involved in buying and selling brands on a regular basis. Ultimately, no appraisal is issued without the final question, "ok, this brand is being bid tomorrow in bankruptcy court --how much, hypothetically, is GB going to write a check for to buy it?" Every appraiser needs to be able to answer that question with authority.

Where does this authority come from? Just as asset liquidation or trading experience is essential for valuing tangible assets, brand acquisition, disposition and management experience is essential for being able to opine on brand values. To this point, Gordon Brothers has bought, sold, managed and appraised numerous consumer product and retailer brands. Lenders should demand qualifications –both appraisal and transactional-- of their brand appraisal shops to ensure they receive accurate net orderly liquidation values.

Here at GBAA, we take the three steps outlined above (field review, database comparison and analysis) to develop a cash-flow value of a brand. Subsequently, we triangulate on the final appraisal value by comparing this discounted cash flow (DCF) model to sale values of similar brands and then finally benchmark against EBITDA multiples. These are the methods we employ for the GB Principal to make the ultimate valuation decision. In essence, it's this balance of art and science that results in accurate brand appraisals.

Valuation Methods

So how are brand valuations actually determined? Appraisals and their valuations can be determined using a combination of three primary methods: market, cost and income. The market approach derives projected values through comparisons to similar transactions using key metrics such as sales and earnings multiples. The cost approach estimates the full expenditure made on the brand, over the life of the brand, to build the brand. The income approach discounts the future projected net cash stream to today's dollars, adjusted for risk. GBAA consumer product brand appraisals use both the market and income approaches (the cost approach is rarely used given the difficulty in accounting for all the expense related to building/replacing the brand over a number of years).

The Income Approach

The income method is predicated on the value of future cash flows an asset generates over its remaining useful life. These cash flows are then discounted using a rate of return reflective of the relevant risk associated with the asset, its cash flows, and the time value of money. The "royalty relief" approach is a form of the income method where the underlying premise is that the brand value is based on the difference between owning the brand and licensing the brand (and therefore having to pay a royalty stream to use it). This method relies on sales forecasts of the brand, an appropriate royalty rate, relevant expenses (i.e. liquidation expenses, any incremental brand management expenses) and an appropriate discount rate.

The sales forecasts used in the royalty relief approach take into account a number of factors: any existing wholesale business, any forecast wholesale business performance (including customer acquisition and retention assumptions), any existing or historic retail business, any existing license agreements in place for royalty revenue, and any future/anticipated license agreements for the brand. To determine the applicable discount rate, GBAA takes into account: the greater level of equity financing required for intangible purchases, the general risk involved in brand purchases, any customer concentration risk, any merchandise or strategic risk, and the greater required return on capital for a financial buyer relative to a strategic buyer.

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In addition to the royalty relief approach, GBAA occasionally uses the income approach to consider the likely interest of strategic buyers in a potential sale of a brand being appraised, taking into account the incremental cash flows and capital requirements likely to be produced by that asset.

The Market Approach

The market method calculates the value of an asset by comparing the assets to similar ones purchased under similar circumstances. A major attraction of the market approach is its simple application when a truly comparable transaction is available.

However, it's often difficult to find comparable assets and transactions. Many transactions take place on a going concern basis, typically involve the entire business (not just the value of the intellectual property), and fail to disclose financial details. Fortunately, GBAA's proprietary Global Recovery Database and continuing experience in the intellectual property sale environment provides us with unique access to data on comparable transactions, particularly those in a Chapter 11 framework.

Key Valuation Factors for Consumer Brands

- Historical and projected sales
- Customer base and concentration
- Competitive and retail positioning
- Historical margins and profitability
- Current licensing agreements
- Comparison to similar transactions

Competitive Environment

It is essential to consider both the brand's competitive market environment (i.e., how it is positioned vis-à-vis competitors), and the competitive sale environment (i.e., which potential acquirers are likely to have interest and capacity to purchase the brand).

GBAA typically considers whether a key retailer may be interested in acquiring the brand as a 'captive' brand. Often, however, it's difficult for a captive brand to match the value derived by a financial buyer or wholesaler retaining national distribution. This situation would not, of course, preclude a retailer from bidding on and/or purchasing the brand for competitive purposes (or with higher future sales expectations than considered) at a price in excess of their own valuation models.

It's important to note, while strategic acquirers typically justify higher purchase prices for the brands, they only need to pay a slight premium over a financial buyer valuation to win within a court-authorized sale environment.

Conclusion

Using our proprietary database of third-party intellectual property sales and licensing transactions, GBAA is able to pinpoint recoveries in distressed sales of intellectual property assets. To formulate bids and determine values, GBAA performs detailed reviews of financial information related to the intangible asset's performance, conducts comprehensive field visits, runs comparisons to the proprietary database and builds an extensive discounted cash flow (DCF) model. The unique perspective of our merchant group provides current, real world insight into various intellectual property values. Bid and appraisal determinations are made by experienced senior professionals who combine market benchmarks with proprietary insights to arrive at an accurate reflection of the orderly liquidation value.

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Our brand appraisals estimate the cash purchase price a financial buyer would pay under a court-authorized liquidation of the brand. The brand is assumed to be stripped away from the other assets (inventory, people, backlog, etc.), somewhat 'tainted' due to the Ch. 11 proceeding, and to incorporate sales disruption as ownership changes hands.

While industry standard income and market valuation methods are used to estimate intellectual property values, GBAA always develops real-world scenarios reflecting specific buyer bid behavior to determine appraised value.

This process differs from the "enterprise valuation" typified by traditional appraisers. The purpose of the GBAA brand appraisal, similar to the purpose of GBAA's other asset appraisals, is to facilitate asset-based lenders in making credit decisions.

Asset-based lenders now have a reliable option for specifically valuing brands and incorporating intangible assets in collateral pools.

Ken Frieze is president of GB Asset Advisors, LLC (GBAA) a division of Gordon Brothers Group, LLC. GBAA provides client companies and financial institutions with comprehensive evaluations and appraisals of retail inventories, wholesale inventories, real estate, commercial and industrial assets, accounts receivable and intellectual property. GBAA appraised over $100 billion of assets during the past three years.

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