DUFF & PHELPS

Valuation Insights

Fourth Quarter 2016
Special Intellectual Property Edition

In this edition of Valuation Insights we discuss several topics related to intellectual property, including a framework for evaluating whether to develop IP in-house or acquire it through a transaction. The article identifies a framework for evaluating the Build vs. Buy decision, including formulating assumptions and identifying challenges that are often encountered during the process.

In our Technical Notes section we discuss how patent rights can be used to exclude competitors from practicing an invention or alternatively how to receive monetary compensation or injunctive relief through the Federal Courts or the U.S. International Trade Commission.

In our International in Focus article we discuss the Internal Revenue Service's proposed regulations to address the tax treatment by multinational corporations of certain asset and business transfers under Internal Revenue Code Sections 367(a) and (d).

These topics and more will be discussed at the Duff & Phelps 3rd Annual IP Value Summit taking place December 7-8, 2016 in Half Moon Bay, California. Join us as we bring together corporate executives, attorneys, investors and other experts to discuss intellectual property best practices, case studies, challenges and opportunities. Attendees can customize their agenda by selecting sessions focused on IP issues in connection with Valuation and M&A, Tax and Transfer Pricing, and Litigation and Licensing. Visit www.duffandphelps.com/IPValueSummit to register.

Read this issue to find out more.

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Valuation Insights Industry Market Multiples are now available online with data back to 2010. Visit **www.duffandphelps.com/multiples** to analyze market multiple trends over time across industries and geographies.

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Lead Story:
Intellectual Property: The Buy vs. Build Decision

Our clients in the technology sector are often faced with a difficult decision: acquire intellectual property and/or proprietary technology (IP) through a transaction, or create it in-house? This article outlines a framework for evaluating these two options, and identifies key considerations in formulating assumptions and identifying challenges that are often encountered during the process.

Are Both Feasible?

Perhaps the most important phase of the Buy vs. Build decision process is the early-stage determination of the feasibility of the two paths. In some cases, IP existing in the marketplace is patented and a lack of known work-arounds means a Build approach would be unrealistic or particularly risky from a litigation perspective. An understanding of the capabilities of potential target businesses and their willingness to engage in a transaction is critical to evaluating the practicality of a Buy strategy. At times, the necessary customization of acquired IP can result in a Build strategy being far more feasible.

If Both Feasible – Model Both Cases

Once it is determined that both Buy and Build options are viable, choosing a path forward is ultimately a strategic investment decision. Generally, as it relates to the determination of quantifiable impacts, the process involves assessing and comparing the net present value of the two options. Typically, this involves the modeling of specific cash flows expected under each option and discounting of such cash flows using an appropriate rate of return.

Factors to Consider

The mechanics of this modeling exercise require the formulation of several key inputs. One of the most critical is the development of a forecast horizon, which is likely to be a function of the time to market advantage of a buy decision vs. building. For instance, what length of time will be required to close the growth gap between the two scenarios, and what are the primary factors driving this convergence? Considerations affecting time to market and revenue generation not only include the amount of time required to create the IP/product in the Build scenario, but also the time required to integrate the purchased IP/product in the Buy scenario. Further, market momentum and the technology adoption cycle should be assessed when evaluating the time to market advantage of a buy decision and relative disadvantage of a build decision.

Buy Considerations

In the Buy scenario, other specific inputs or considerations may include deal costs (legal, due diligence, etc.), integration costs (IT/operations, severance, transition services, etc.), and the impact of any anticipated amortization resulting from the acquisition (on GAAP financials and/or on cash taxes). To the extent quantifiable, transaction-related risks can be considered; such as integration, employee retention, the Buyer's existing sales capacity and ability to sell immediately, and potential negative reactions of existing customers of the target.

Build Factors

Build scenario inputs will likely include the direct and indirect costs necessary to create the IP and the rate of market penetration once completed. Build-related risks could include the risk of technological failure, the risk that in-house skills are ultimately not aligned with the task, or even the notion that cost and revenue projections in this scenario are likely to include a greater margin of estimation error than the projections used in a Buy scenario.

Other Considerations

There are a number of other potential implications that may be more difficult to quantify. For instance, what talent is being acquired along with the IP and how critical is the retention of these employees to the successful exploitation and integration of the IP and execution of the overall business model? Is it feasible for development to be outsourced to offshore resources, and what is the opportunity cost incurred by engaging existing in-house resources to Build versus focusing on other internal initiatives?

Join Us for the Discussion

At the Duff & Phelps 2016 IP Value Summit taking place December 7 - 8, 2016, at the Ritz Carlton in Half Moon Bay, California, technology sector participants and valuation experts will address this topic during "The Buy vs. Build Decision in IP Transactions: Practical Applications" panel, which is part of the afternoon Valuation and M&A track.

The session will consist of an interactive discussion with industry participants regarding their approach to Buy vs. Build analyses. Our panelists will share insight based on their real-world experiences as it relates to these evaluations, and will also review specific examples of Buy vs. Build analyses to help illustrate the conceptual fundamentals and modeling techniques.

If the Buy vs. Build decision is one that you encounter in your business or interests you or your clients generally, please consider joining the conversation and attending the Duff & Phelps IP Value Summit. Additional details and complimentary registration can be found at: http://www.duffandphelps.com/IPValueSummit

CPE and CLE credit are available.

For more information contact Glen Kernick, Managing Director and Global Technology Industry Leader, at +1 650 798 5573 or Justin Kloos, Director, at +1 678 916 2568.

Technical Notes:
Using Patent Rights to Exclude Competitors

Using Patent Rights to Exclude Competitors

The U.S. patent system is designed to encourage innovation by creating incentives to make the types of significant, long-term investments that serve the public interest. In exchange for "laying open" an invention to the public, the patentee is entitled to certain legal rights during the term of the patent. These legal patent rights can include the right to exclude others from practicing the invention, or the right to receive monetary compensation from others practicing the invention.[1] However, these patent rights are not automatically enforced, so the patentee may be required to bring an infringement action in order to receive either injunctive or monetary relief.[2] Of these, patentees who seek injunctive-type relief have the option to pursue enforcement in both Federal Court and the United States International Trade Commission (ITC).

Injunctive Relief in the Federal Courts

While a patentee may advocate for one legal remedy over the other, a 2006 Supreme Court decision in *eBay Inc. v. MercExchange, L.L.C.* established that a successful patent infringement claim does not automatically entitle a patentee to injunctive relief.[3] The *eBay* decision requires the federal courts to consider the equities of a particular case before granting an injunction using four equitable factors: (i) irreparable harm; (ii) inadequacy of other remedies, such as monetary damages, available at law; (iii) the balance of hardships; and (iv) the public interest.[4] In order for the harm to be irreparable, monetary damages must not be adequate to compensate for the infringement. In the wake of the *eBay* decision, studies found that the percentage of permanent injunctions granted to patentees following a successful infringement action fell from about 95 percent[5] to about 75 percent.[6]

More recently, for patentees seeking to enjoin the sale of infringing devices early on in the litigation process, the U.S. Court of Appeals for the Federal Circuit has introduced a new "casual nexus" inquiry as part of the irreparable harm calculus for preliminary injunctive relief.[7] The causal nexus inquiry is said to promote fair competition and is a "flexible analysis" that requires "the patentee to show 'some connection' between the patented features and the demand for the infringing products."[8]

Exclusion Orders in the ITC

Patentees seeking to exclude others from practicing a patented invention may also elect to file a complaint with the ITC, an independent federal agency with quasi-judicial authority and broad investigative responsibilities on matters of trade in the United States.[9] The ITC is responsible for investigating "unfair practices in import trade" under Section 337 of the Tariff Act of 1930, and has the authority to ban the importation of articles into the United States that are found to infringe domestic intellectual property rights.[10]

Section 337 allows intellectual property owners to petition for relief of infringement in the form of cease and desist orders and limited or general exclusion orders. Such remedial orders prohibit the entry of infringing products into the United States. While the ITC applies very similar patent infringement standards as federal courts, the ITC is an administrative agency and it is not bound by the Supreme Court's discretionary test for injunctive relief in *eBay*.[11] Complaints filed by patentees with the ITC have grown significantly during the past decade, and the number of active ITC investigations has grown from 70 during 2006 to at least 100 during 2016 (as of the third quarter of 2016).[12]

ITC investigations are distinct from federal court proceedings in that to qualify for protection under Section 337, the ITC requires both technical proof of patent infringement and economic proof that the patentee is engaged in a domestic industry. The ITC finds proof of a domestic industry as long as the patentee meets one of three economic requirements in the United States: (i) significant investment in plant and equipment; (ii) significant employment of labor or capital; or (iii) substantial investment in a patent's exploitation.[13] Patentees who are successful in satisfying the technical and economic requirements of an ITC investigation are almost always granted injunctive-type relief.[14] However, unlike federal courts, the ITC cannot award monetary damages for findings of infringement.

Join Us for a Discussion

Panelists at the Duff & Phelps 2016 IP Value Summit will explore the latest standards for injunctive relief in the Federal Courts and the ITC during the "Competitors and the Right to Exclude" panel, which is part of the afternoon Licensing and Litigation track.

The applicable standards for injunctive relief and irreparable harm continue to evolve. The Intellectual Property Disputes practice at Duff & Phelps follows the changing patent litigation landscape closely and has meaningful experience in matters involving injunctive relief (including analyses of irreparable harm and ongoing royalties) and international trade issues (including analyses of domestic industry and bonding).

For more information contact Sheri Rock, Director, Intellectual Property Disputes, at +1 713 237 5375.

1. 35 U.S. Code § 154 (2012)
2. WIPO Intellectual Property Handbook: Policy, Law and Use (2004). See Chapter 2: Fields of Intellectual Property Protection at 17
3. *eBay Inc. v. MercExchange, L.L.C.*, 547 U.S. 388, 391 (2006)
4. *eBay Inc. v. MercExchange*, L.L.C., 547 U.S. 388, 391 (2006)
5. Colleen V. Chien & Mark A. Lemley, *Patent Holdup, the ITC, and the Public Interest* (Cornell Law Rev. 2012) at 10
6. *See*, e.g. Federal Trade Commission, The Evolving IP Marketplace: Aligning Patent Notice and Remedies with Competition (March 2011) at 217; and Post-eBay Permanent Injunction Rulings in Patent Cases to 12-31-13 www.patentstats.org
7. *See*, e.g. *Apple, Inc. v. Samsung Elecs. Co., Ltd.*, 695 F.3d 1370, 1374 (Fed. Cir. 2012); and *Apple Inc. v. Samsung Elecs. Co. Ltd.*, 735 F.3d 1352, 1361 (Fed. Cir. 2013)
8. *Apple Inc. v. Samsung Elecs. Co.*, 809 F.3d 633, 641 (Fed. Cir. 2015), cert. denied, 136 S. Ct. 2522 (2016)
9. www.usitc.gov/press_room/about_usitc.htm
10. 19 U.S.C. § 1337
11. *Spansion v. ITC*, 629 F.3d 1331 (Fed. Cir. 2010)
12. www.usitc.gov/intellectual_property/337_statistics_number_new_completed_and_active.htm
13. 19 U.S.C. § 1337(a)(3)
14. www.usitc.gov/intellectual_property/337_statistics_remedial_orders_issued_leo_v_geo.htm

International in Focus: The Impact of Internal Revenue Code Section 367 on Outbound Asset Transfers

On September 14, 2015, the Internal Revenue Service (the IRS) issued proposed regulations (the "Proposed Regulations") to address the tax treatment by multinational corporations of certain asset and business transfers under Internal Revenue Code ("IRC") Sections 367(a) and (d). The Proposed Regulations would result in the following significant changes: (1) a narrowing of the Section 367(a)(3) "active trade or business" (ATOB) exception, and (2) the elimination of the exception for transfers of foreign goodwill and going concern value (FGWGCV) used in an active foreign trade or business.

If finalized, the Proposed Regulations would restrict any tax-deferred outbound asset transfers to certain tangible and financial assets. FGWGCV would be subject to tax, under either sections 367(a) or 367(d), regardless of whether the particular intangible asset is described in Section 936(h)(3)(B), and regardless of whether the assets will be used in an ATOB outside the U.S.

Background

Section 367(a) provides that if, under certain circumstances, a U.S. transferor transfers property to a controlled foreign corporation (CFC), the U.S. transferor is required to recognize gain on the outbound transfer except when used in an ATOB outside of the U.S. However, certain types of property do not qualify for the ATOB exception, including copyrights, inventory, accounts receivable and "intangible property" (IP) as defined by Section 936(h)(3)(B), which is subject to Section 367(d).

Under the current Regulations under 367(d), the FGWGCV is not included in the IP base subject to tax under Section 367. Goodwill or going concern value is defined as the residual value of a business operation after all other tangible and intangible assets have been identified and valued, including the right to use a corporate name in a foreign country.

The Proposed Regulations, on the other hand, provide that no IP (including FGWGCV) can qualify for the ATOB exception under Section 367(a) as proposed, even if the IP transferred is, in fact, used in a trade or business operating outside of the U.S. Instead, taxpayers must choose to apply Section 367(d) instead of Section 367(a), and must include an amount in taxable income over the useful life of the FGWGCV. This is in spite of the fact that Congress, in the past, indicated that "the transfer of goodwill or going concern value developed by a foreign branch to a newly organized foreign corporation should not result in abuse of the U.S. tax system." Additionally, there has been criticism of the Proposed Regulations by both practitioners and multinational organizations which contend that the IRS is likely to face significant challenges if the rules are passed in their current form as the inclusion of FGWGCV in intangible value is contrary to Congressional intent of the 367 rules.

Valuation Implications

The IRS seems to believe that taxpayers have ascribed an inappropriately large portion of the value of property transferred in an outbound transaction to FGWGCV. The preamble to the Proposed Regulations asserts that some taxpayers valued the property transferred in a manner contrary to the transfer pricing rules under Section 482 in order to minimize the value of property described in Section 936(h)(3)(B), and the corresponding deemed income exclusion that would be required under Section 367(d). The Proposed Regulations imply that a broader view be taken on the value of IP being transferred outside of the U.S.

Despite vocal criticism, the IRS recently issued auditor guidelines which suggest that a functional analysis be performed in order to properly identify FGWGCV, as distinct from domestic goodwill and going concern value. On the surface, it appears as though the IRS may require taxpayers to bifurcate domestic from foreign GWGCV: "if there is an active foreign trade or business with goodwill or going concern value, determine whether the customer base relating to the transferred IP includes U.S. customers that may constitute domestic GWGCV, and thus would not constitute FGWGCV." From a valuation standpoint, however, an existing customer base or customer list, is typically viewed as an intangible asset, with goodwill representing the expectation of future customers. It is not uncommon that the valuation of customer relationships be undertaken in a purchase price allocation, with a portion of this value accruing to foreign customers, depending upon the target company's reporting unit structure. The IRS admits the challenge in valuing FGWGCV by stating that "the determination of the correct amount of FGWGCV is beyond the scope of this Practice Unit and would require the assistance of an economist."

Although the intent of the IRS in the Proposed Regulations is to cast a broader net as to which assets are subject to taxation, it will be important to taxpayers that the final regulations be clear in defining FGWGCV as distinct from the value of customer-based intangible assets. It will also be important that the prescribed valuation methodologies be articulated, and that they be consistent with standards accepted by both the business valuation and transfer pricing communities. Likewise, creating a broader definition of taxable IP without additional Congressional support will lead to additional controversy between the IRS and US based multinationals.

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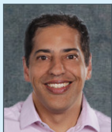
THE RITZ-CARLTON HALF MOON BAY
DECEMBER 7-8, 2016

Keynote Speakers



Micky Minhas
Chief Patent Counsel
Microsoft

James Pooley
Senior Counsel
Orrick, and driving force behind the newly adopted Defend Trade Secrets

Join us as we bring together corporate executives, attorneys, investors and other experts to discuss intellectual property best practices, case studies, challenges and opportunities.

The **3rd Annual IP Value Summit** is designed for IP and Licensing Professionals, General Counsel, Attorneys, Tax Professionals, CEOs, CFOs, Controllers, M&A Heads and other industry professionals.

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- Tax and Transfer Pricing
- Litigation and Licensing

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North American Industry Market Multiples
As of September 30, 2016

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Industry	Market Value of Equity to Net Income		MVIC to EBIT		MVIC to EBITDA	
	U.S.	Canada	U.S.	Canada	U.S.	Canada
Energy	15.9	28.8	19.8	26.9	13.2	12.5
Energy Equipment & Services	12.0	12.0	18.5	17.8	11.8	10.9
Integrated Oil & Gas	—	—	—	—	17.2	—
Materials	19.5	17.9	15.5	20.0	10.3	11.2
Chemicals	20.7	19.4	15.5	18.6	10.9	10.4
Diversified Chemicals	—	—	13.8	—	11.4	—
Specialty Chemicals	22.9	—	15.9	—	11.9	—
Construction Materials	23.3	—	16.6	—	9.7	—
Metals & Mining	15.9	17.4	16.0	32.8	9.8	12.5
Paper & Forest Products	17.6	18.4	14.4	15.6	8.9	7.6
Industrials	19.8	18.5	15.2	16.3	10.7	10.9
Aerospace & Defense	17.9	12.4	15.7	17.5	12.1	12.3
Industrial Machinery	22.4	31.4	16.8	16.6	11.7	10.5
Commercial Services & Supplies	22.6	13.9	16.2	18.9	10.2	7.3
Road & Rail	16.8	18.8	13.4	14.5	7.4	11.0
Railroads	18.2	—	14.2	—	10.5	—
Consumer Discretionary	17.5	17.7	13.7	15.3	10.0	11.5
Auto Parts & Equipment	14.6	7.9	10.7	7.5	7.5	5.5
Automobile Manufacturers	—	—	—	—	—	—
Household Durables	15.2	—	13.4	—	11.2	—
Leisure Equipment & Products	17.6	—	12.6	—	10.1	—
Textiles, Apparel & Luxury Goods	18.0	—	12.5	—	10.4	—
Restaurants	21.7	17.8	16.3	14.2	9.6	16.4
Broadcasting	15.4	16.4	13.6	17.5	9.8	11.5
Cable & Satellite	26.0	—	18.8	13.0	11.9	8.3
Publishing	27.0	—	13.5	12.5	9.8	8.1
Multiline Retail	15.3	—	12.4	—	9.2	—

Industry	Market Value of Equity to Net Income		MVIC to EBIT		MVIC to EBITDA	
	U.S.	Canada	U.S.	Canada	U.S.	Canada
Consumer Staples	22.0	23.7	16.3	16.8	13.0	12.0
Beverages	25.4	24.7	19.9	22.8	16.6	15.1
Food Products	20.4	27.6	17.4	15.7	14.1	11.1
Household Products	26.1	—	17.6	—	13.9	—
Health Care	25.8	41.2	19.4	20.2	14.7	14.1
Health Care Equipment	39.9	—	25.0	—	18.4	—
Health Care Services	19.0	—	15.5	—	11.2	—
Biotechnology	17.6	45.4	19.8	14.3	19.1	12.2
Pharmaceuticals	29.1	—	19.4	18.9	13.8	15.7
Information Technology	26.1	20.7	22.0	16.4	16.2	14.1
Internet Software & Services	26.8	16.8	25.6	13.6	19.0	12.8
IT Services	26.1	29.1	19.7	17.6	13.6	14.1
Software	33.9	32.4	28.3	29.8	20.8	21.3
Technology Hardware & Equipment	23.3	17.6	18.0	12.0	13.4	10.5
Communications Equipment	25.1	20.8	19.4	13.8	15.2	11.0
Computers & Peripherals	15.8	—	13.7	—	12.1	—
Semiconductors	31.5	—	32.2	—	20.6	—
Telecommunication Services	17.6	—	17.7	16.2	7.7	9.4
Integrated Telecommunication Services	15.0	—	16.1	—	6.4	—
Wireless Telecommunication Services	32.5	—	33.5	—	8.1	—
Utilities	22.8	19.4	18.3	28.5	11.4	14.2
Electric Utilities	22.2	—	17.9	—	10.6	—
Gas Utilities	23.6	—	16.8	—	11.2	—

Industry	Market Value of Equity to Net Income		Market Value of Equity to Book Value	
	U.S.	Canada	U.S.	Canada
Financials	15.7	11.5	1.1	1.3
Commercial Banks	15.8	12.0	1.1	1.6
Investment Banking and Brokerage	17.3	—	1.7	1.1
Insurance	14.1	12.1	1.2	1.4

An industry must have a minimum of 5 company participants to be calculated. For all reported multiples in the U.S. and Canada, the average number of companies in the calculation sample was 79 (U.S.), and 25 (Canada); the median number of companies in the calculation sample was 39 (U.S.), and 10 (Canada). Sample set includes publicly-traded companies (private companies are not included). Source: Data derived from Standard & Poor's Capital IQ databases. Reported multiples are median ratios (excluding negatives). MVIC = Market Value of Invested Capital = Market Value of Equity plus Book Value of Debt. EBIT = Earnings Before Interest and Taxes for latest 12 months. EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization for latest 12 months.

European Industry Market Multiples
As of September 30, 2016

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Industry	Market Value of Equity to Net Income	MVIC to EBIT	MVIC to EBITDA
	Europe	Europe	Europe
Energy	10.2	15.9	8.8
Energy Equipment & Services	13.4	16.3	8.9
Integrated Oil & Gas	—	43.6	10.7
Materials	17.9	15.6	9.6
Chemicals	19.3	15.3	10.3
Diversified Chemicals	20.8	14.9	8.3
Specialty Chemicals	22.2	15.7	11.5
Construction Materials	18.8	16.0	9.5
Metals & Mining	18.6	20.0	10.0
Paper & Forest Products	12.5	13.6	8.3
Industrials	18.3	15.9	11.0
Aerospace & Defense	19.0	20.5	11.7
Industrial Machinery	19.4	16.5	11.7
Commercial Services & Supplies	20.2	15.6	9.9
Road & Rail	12.7	14.4	7.5
Railroads	12.6	18.7	8.2
Consumer Discretionary	17.1	15.3	10.8
Auto Parts & Equipment	15.2	13.2	8.5
Automobile Manufacturers	7.8	15.2	11.1
Household Durables	14.2	12.2	10.3
Leisure Equipment & Products	17.9	16.8	13.0
Textiles, Apparel & Luxury Goods	18.6	15.9	11.2
Restaurants	19.7	15.9	11.1
Broadcasting	16.3	15.0	12.1
Cable & Satellite	—	29.0	11.7
Publishing	13.6	14.8	10.4
Multiline Retail	18.3	15.2	12.5
Consumer Staples	19.3	17.2	11.9
Beverages	23.3	18.7	12.9
Food Products	17.8	16.3	11.4
Household Products	19.9	15.3	11.2

Industry	Market Value of Equity to Net Income	MVIC to EBIT	MVIC to EBITDA
	Europe	Europe	Europe
Health Care	26.8	22.1	16.2
Health Care Equipment	29.5	23.2	16.4
Health Care Services	20.7	15.5	12.1
Biotechnology	52.7	32.1	27.3
Pharmaceuticals	23.0	20.9	16.0
Information Technology	22.7	19.2	14.5
Internet Software & Services	25.8	24.1	19.5
IT Services	19.2	14.6	12.2
Software	27.9	22.2	17.2
Technology Hardware & Equipment	20.9	18.1	12.8
Communications Equipment	18.9	18.6	14.1
Computers & Peripherals	21.5	19.5	12.5
Semiconductors	24.6	26.2	14.8
Telecommunication Services	23.9	19.1	9.9
Integrated Telecommunication Services	20.8	18.0	8.8
Wireless Telecommunication Services	27.9	22.2	9.0
Utilities	15.6	17.7	10.1
Electric Utilities	16.4	17.1	10.1
Gas Utilities	13.3	13.8	10.5

Industry	Market Value of Equity to Net Income	Market Value of Equity to Book Value
	Europe	Europe
Financials	12.7	1.0
Commercial Banks	9.3	0.6
Investment Banking and Brokerage	18.1	1.6
Insurance	12.6	1.1

An industry must have a minimum of five company participants to be calculated. For all reported multiples in Europe, the average number of companies in the calculation sample was 90 and the median number of companies in the calculation sample was 38 Sample set includes publicly-traded companies (private companies are not included). Source: Data derived from Standard & Poor's Capital IQ databases. Reported multiples are median ratios (excluding negatives). MVIC = Market Value of Invested Capital = Market Value of Equity plus Book Value of Debt. EBIT = Earnings Before Interest and Taxes for latest 12 months. EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization for latest 12 months.

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