Tangible and Intangible Property Valuation Due Diligence Procedures

Casey D. Karlsen and Robert F. Reilly, CPA

One component of many asset-based approach business valuation analyses is the valuation of the subject company's tangible property assets and/or intangible property assets. This discussion summarizes what valuation analysts ("analysts")—and other parties who rely on business valuation analyses—need to know about the analyst's property valuation due diligence procedures.

Introduction

The asset-based approach to business valuation involves the valuation of the tangible property and the intangible property of the subject business entity. This statement is obvious for the application of the asset accumulation ("AA") method of the asset-based approach. This statement is also true for the application of the adjusted net asset value ("ANAV") method of the asset-based approach.

The ANAV method typically involves the aggregate revaluation of all of the subject company assets through the application of the capitalized excess earnings method ("CEEM"). The CEEM quantifies one of the following:

1. Aggregate intangible value in the nature of goodwill (i.e., the total valuation adjustment to the subject company net asset value)
2. Aggregate economic obsolescence to be applied to all company assets valued by reference to the cost approach

However, the ANAV method can also involve the revaluation of individual categories of subject company tangible property or intangible property.

Accordingly, valuation analysts ("analysts") may also include the revaluation of individual categories of tangible property or intangible property in the application of the business valuation asset-based approach.

For purposes of this discussion, tangible property includes (1) real estate and (2) tangible personal property. And, for purposes of this discussion, intangible property includes (1) intangible real property, (2) intangible personal property, and (3) intellectual property.

This discussion focuses on the due diligence procedures that analysts should perform in the process of valuing tangible property and intangible property in the application of the asset-based approach analysis.

Before starting the quantitative valuation analysis, the analyst should understand:

1. the subject company assets and
2. the bundle of legal rights subject to the valuation.

The analyst should also understand the business-valuation-related purpose and objective of the property valuation.

The analyst should understand that the asset-based approach is a generally accepted business valuation approach that may be used for transaction, taxation, financing, planning, litigation, or other purposes.

Before selecting and performing the property valuation procedures, the analyst should perform reasonable due diligence procedures. This discussion summarizes both the data gathering procedures and the due diligence procedures that analysts typically conduct during the asset-based approach valuation of the subject company tangible property or intangible property.

Subject Company Data Gathering

If this information is available and relevant, the analyst typically requests information from the subject company with respect to the following:

1. The historical development and maintenance of the subject property categories or asset(s)
2. The subject company business operations
3. The operations of the individual subject company asset(s)

Sometimes, such subject company information simply is not available. It is not uncommon for subject companies to create (or maintain) relatively few documents or data regarding the operation of their individual assets. If the analyst is working for an opposing litigant, it may be difficult to obtain all of the asset-specific information that he or she would like.

Also, depending on the type of subject company asset and on the property valuation approach selected, certain information may be more or less relevant. For a subject company asset that may be valued using a cost approach method, information regarding the asset development process may be particularly relevant. For a subject company asset that may be valued using an income approach method, information regarding the asset development process may be less relevant.

The analyst may inquire about the subject company general business operations. The subject company business operations are the environment in which the asset actually operates. In these inquiries, the analyst may request descriptions of the following:

1. How the asset functions within the subject company
2. How the asset contributes to the operations of the company
3. How the asset functions with respect to other subject company tangible assets and intangible assets
4. How company employees use, maintain, protect, or commercialize the asset

The analyst may inquire about the operation of the asset within the company. In these inquiries, the appraiser may also pose the following questions:

1. Does the asset contribute to the generation of the company operating income?
2. Does the asset contribute to the generation of company ownership (i.e., royalty) income?
3. Has the company ever been approached with a sale, license, or other offer regarding the asset?

Subject Company Asset Data Gathering

In any business-valuation-related property appraisal, the analyst typically considers the economic benefits related to the subject asset. These economic benefits could be considered from the perspective of the current owner/operator company, another individual owner/operator, or the market in general (or the population of hypothetical asset owner/operators).

These asset-generated economic benefits could include any or all of the following:

1. Some measure of operating income
2. Some measure of license income
3. Some protection of alternative income sources (e.g., through forbearance)
4. Some measure of risk reduction (e.g., through licenses, contracts, or other competitive advantages)
5. Some deferral or reduction of expenses, capital costs, or other investments

The analyst may inquire as to how the subject company management perceives the economic benefits associated with the individual asset or property. This inquiry could include the historical benefits to the subject company, the current benefits to the subject company, and/or the prospective benefits to subject company.

The subject company management is often in a knowledgeable position to identify and quantify these economic benefits. However, the analyst should be mindful that the company management is not the analyst. Therefore, the analyst should perform reasonable due diligence procedures with regard to any data provided by the subject company management.

"[T]he analyst may be interested in the company management's ability to accurately predict future results of operations."

Due Diligence Procedures for the Subject Company Data

With regard to the historical benefits from the asset/property ownership, the analyst may compare such company-provided statements with the company historical financial statements. Presumably, the claimed revenue increase, expense decrease, or any other asset economic benefits are evident in the company historical results of operations.

Likewise, the impact of any asset or property benefits may be included in the subject company current financial statements. That is, whatever economic benefit that is identified by the subject company (e.g., increased product selling price, decreased operating expense, etc.) may be encompassed in the company results of operations.

Often, the company management expresses the subject asset or property benefits in terms of financial or operational projections. This economic contribution is converted into a value indication when the analyst performs a profit split, multiperiod excess earnings, capitalized excess earnings, or similar property valuation method analysis.

Before performing such property valuation analyses, the analyst should subject these financial projections to various due diligence procedures, including the following:

1. The analyst should compare the historically prepared financial projections to the company historical results of operations; whether the previous projections relate to the subject asset or to the overall company, the analyst may be interested in the company management's ability to accurately predict future results of operations.
2. The analyst should compare the current financial projections to any current company capacity (or other) constraints; the analyst may consider if the asset-related projections exceed the current plant capacity (without additional capital expenditures), assume new product/service introductions (without additional R&D expenditures), or exceed current regulatory requirements (e.g., the number of certificate of need patient beds for a hospital or the environmental discharge limitations for an oil refinery).
3. The analyst should compare the financial projections to guideline public company financial projections. Many publicly traded guideline companies provide multiyear financial projections to the market of security analysts; security analysts also provide multiyear financial projections for the publicly traded guideline companies that they follow. The analyst may consider if the company projection variables (e.g., growth rates, profit margins) are (or are not) in line with guideline public company financial projections.
4. The analyst should compare the company financial projections to published industry benchmark projections. Trade associations, financial reporting agencies, industry consultants, and others publish both (a) compilations of industry financial ratios and (b) outlook projections for various industries. The analyst may consider the reasons why the company projection variables (e.g., growth rates, profit margins) are not in line with published industry benchmarks.

Strategic and Competitive Analysis

Before selecting or performing any property valuation methods, typically the analyst will consider the competitive position of the subject asset or property. This procedure often involves an assessment of the subject asset competitive strengths, weaknesses, opportunities, and threats ("SWOT").

This SWOT assessment is often performed by comparing the subject asset to the corresponding assets of the subject company competitors. Typically, the analyst will consider the SWOT position of the subject tangible or intangible property within the SWOT position of the subject company.

As part of due diligence, the analyst may consider the following questions with regard to the tangible or intangible property's SWOT:

1. How important is the property to the subject company?
2. What would the subject company do if the property did not exist?
3. Does the property protect the subject company from competition?
4. Is the property susceptible to infringement or other wrongful use?
5. Does the subject company adequately protect, improve, and commercialize the property type?

6. Is the property primarily used to defend other assets or income sources?
7. Could the property category be further commercialized (e.g., through licensing)?
8. Do the subject company customers, stockholders, and other stakeholders perceive the value of the property category?
9. When practical, is the property safeguarded through contracts, nondisclosure agreements, noncompetition agreements, and documentation safekeeping practices?
10. Is the property subject to obsolescence influences of any type?
11. How does the subject company tangible or intangible property compare to comparable property owned by competitor companies?
12. How susceptible is the utility and value of the property to changes in its operating environment?
13. How easily can the property be replaced using alternatives from the marketplace?

The analyst may consider these general competitive factors (1) when assessing the reasonableness of the economic benefits (and other data) provided by the company and (2) when selecting the appropriate property analyst approach or approaches.

Due Diligence Inquiries

If these data are available and relevant, the analyst may investigate the following lines of inquiry:

1. The subject company operations before the development of the tangible or intangible property
2. The subject company operations without the existence of the property
3. The competitors' operations without the subject property category
4. How the subject property differs from the competitors' corresponding property
5. The property's life cycle, at the subject company specifically or in the industry generally

If such access to management is available, the analyst may inquire as to how the company functioned before the purchase or development of the current version of the tangible or intangible property. The analyst may consider the following questions:

1. Was there a time when the subject company did not have any version of the property?
2. What was the impact on the subject company of developing (or buying) the tangible or intangible property?
3. Were there previous versions of the tangible or intangible property?
4. When and how were the previous property versions created?
5. Did the property naturally evolve over time (e.g., an assembled workforce) or are there discrete generations of the property (e.g., a patent or license)?

The analyst may also inquire as to how the subject company would hypothetically function if it did not have access to the tangible or intangible property. The analyst may consider the following questions:

1. Would the subject company buy or build a replacement property?
2. Could the subject company buy or build a replacement property?
3. How would the subject company replace the property?
4. Could the subject company function with the current version of the property?
5. Could the subject company function with any prior version of the property?

In addition, the analyst may inquire as to how the subject company's industry competitors function without the tangible or intangible property. Let's say that while the subject company enjoys the use of the tangible or intangible property, its competitors do not. Its competitors may or may not have assets that are comparable (or, at least, corresponding) to the tangible or intangible property.

Therefore, the analyst may consider the following questions:

1. Do industry competitors have property types that correspond to the subject (or, is the subject property unique in the industry)?
2. Did the competitors build or buy their corresponding property?
3. Are there discernible generations of the corresponding property in the industry?

"The analyst should consider available data related to the risk factors affecting the property category."

4. Have any competitors recently been acquired and, if so, do the acquirers report the fair value of the corresponding property categories in any public financial statements?
5. Are there any competitors who operate without a corresponding property category and, if so, how?

Property Valuation Due Diligence Additional Analyst Considerations

When performing these tangible and intangible property valuation due diligence procedures, the analyst may consider the following issues:

1. Prior to the asset-based approach analysis, the subject company may have never previously considered the valuation of the tangible or intangible property. Therefore, the analyst should not be surprised if the company management does not have the related documents and data immediately available. Also, the analyst should not be surprised if the company management does not have immediate answers to the analyst's due diligence questions. The company management may have never before received similar inquiries about its tangible or intangible property. Therefore, if data are available, it may take management a relatively long time to compile the data and transmit it to the analyst.
2. The analyst should not be surprised if the company management does not have data and documents that are specifically related to the property category. The analyst may have to accept information related to the business unit that uses the property category—because there is typically no financial accounting or other requirement for the subject company to maintain property-specific information.
3. The analyst should consider available data with regard to property maintenance expenditures. This is because most assets require some level of maintenance expenditures in order to stay operational and competitive. The analyst may consider if such expenditures are material to the subject company. If so, the analyst should somehow consider such expenditures in the property valuation analysis. For example, such consideration could be made in the estimate of the asset obsolescence.
4. The analyst should consider available data with regard to the competition in the subject company's industry. This consideration may include any available data with respect to the corresponding tangible or intangible property operated by the competitors.
5. The analyst should consider available data related to the risk factors affecting the property category. Such risk factors may include the expected impact of obsolescence, potential regulatory changes, competitive weaknesses and threats related to the subject company, legal challenges to the property type, and other factors.
6. The analyst should consider available data regarding expenditures or efforts required to legally protect the tangible or intangible property. These expenditures and efforts could be defensive (i.e., to defend against legal or regulatory challenges) or offensive (i.e., to prosecute breach of contract, infringement, or other legal claims) in nature.
7. The analyst should consider the contractual implications of the tangible or intangible property. To the extent that the asset is the creation of a contract or is obligated to perform according to a contract, the analyst may consider these contractual implications.
8. The analyst may consider alternative perspectives regarding the property category from within the subject company, if possible. Some property categories are so user-specific that only a small subset of company personnel are knowledgeable regarding the property type. In other cases, the analyst may be able to obtain information from various company personnel in various departments.
9. The analyst should maintain clear documentation as to which members of management provide each relevant document. This item may be especially important at later stages of the valuation analysis to explain how certain valuation variables were selected.

Summary and Conclusion

Valuation analysts are often asked to value the subject company individual assets—that is, real estate, tangible personal property, intangible real property, and intangible personal property—as part of the asset-based approach to business valuation.

These property valuations are typically performed as part of the AA business valuation method. And, these property valuations may also be performed as part of the ANAV business valuation method.

The analyst typically obtains most of the asset-specific valuation information from the subject company management. Such information may include the following:

- The owner/operator company financial documents and operational data
- Summaries of historical development costs and efforts
- Estimates of economic benefits and other prospective financial information
- Other relevant documents

However, depending on what party the analyst is working for in the business valuation engagement, he or she may not have direct access to the subject company management.

In all cases, the analyst will consider reasonable due diligence procedures with regard to the tangible property or intangible property information. These property valuation due diligence procedures could relate to historical, contemporaneous, and prospective information.

Many of the tangible and intangible property valuation due diligence procedures are comparative in nature. That is, the analyst may compare the subject tangible or intangible property information to:

1. subject company historical information benchmarks,
2. subject company capacity or other constraints,
3. guideline public company benchmarks,
4. competitor industry benchmarks, and
5. guideline sale or license transaction data.

A competitive (or SWOT) assessment is a common property valuation due diligence procedure. In that procedure, the analyst assesses the reasonableness of the tangible or intangible property economic benefits to the owner/operator. As part of the competitive analysis, the analyst may consider the following:

1. How the owner/operator company functioned before the purchase or development of the property category
2. How the owner/operator company would function without the property category
3. How the owner/operator company competitors function without the property category.

"The analyst typically obtains most of the asset-specific valuation information from the subject company management."

When the analyst receives asset-specific information from the owner/operator company, the analyst should be aware that the subject company management:

1. may never have assembled this type of information before,
2. may not maintain asset-specific data and documents,
3. may not consider all maintenance and legal expenses in the response, and
4. may not consider all risk factors (including obsolescence considerations) in the response.

Even with these caveats, the analyst will typically gather as much asset development and operation information as possible to use in the valuation of the subject company's real estate, tangible personal property, intangible real property, intangible personal property, or intellectual property.

All of this information may be useful to the analyst in the property category valuation phase of the asset-based approach business valuation.

Casey Karlsen is an associate in our Portland, Oregon, practice office. Casey can be reached at (503) 243-7513 or at cdkarlsen@willamette.com.

Robert Reilly is a managing director of the firm and is resident in our Chicago practice office. Robert can be reached at (773) 399-4318 or at rfreilly@willamette.com.