# Perspectives
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## THE APPLICATION OF THE RELIEF FROM ROYALTY METHOD FOR INTELLECTUAL PROPERTY VALUATION

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The relief from royalty method is a generally accepted valuation method for the analysis of intellectual property assets that may generate royalty income. Valuation analysts applying the relief from royalty method should be familiar with the procedural steps and key considerations of the method.

### Introduction

Valuation analysts often are engaged to assess intangible assets in the context of transactions or financial reporting. Intangible asset valuations may be performed for intercompany transfer pricing, litigation support, bankruptcy proceeding, and tax planning purposes.

In many of these cases, the results are subject to review by regulators and other interested parties. As a result, intangible asset valuations can have significant economic implications for the parties involved. Therefore, it is prudent to follow established procedures and best practices to ensure the credibility and defensibility of an intellectual property valuation.

The value of an intangible asset is typically associated with the bundle of legal rights associated with the asset, rather than its physical qualities. The three commonly applied intangible asset valuation approaches are:

1. Cost approach – What is the cost to develop a substitute intangible asset? What is the utility of the substitute intangible asset relative to the subject intangible asset?
2. Market approach – What are the sales prices or licensing terms of comparable intangible assets? What are the similarities and differences of the subject intangible asset relative to the comparable intangible assets?
3. Income approach – What is the prospective amount of intangible asset income? What is the duration of intangible asset income? What present value discount rate should be applied to the intangible asset income?

The relief from royalty ("RFR") method—and other royalty-based valuation methods—is often categorized as a market approach method. This is because selected royalty rates used for analysis are extracted from

market data. However, the RFR method also has certain characteristics of an income approach method. The RFR method incorporates the projection of revenue, the selection of the appropriate present value discount rate, and the present value of the projection of royalty income or royalty expense savings, all of which are common in the income approach.

The RFR method is a generally accepted method in an intellectual property ("IP") intangible asset valuation analysis. IP is a category of intangible asset that is recognized by law and includes intangible assets such as trademarks, copyrights, patents, and trade secrets.

This discussion focuses on the application of the RFR for IP valuation.

THE FIRST PROCEDURE IN THE RFR METHOD IS TYPICALLY TO ESTIMATE A ROYALTY RATE THAT AN INDEPENDENT PARTY WOULD BE WILLING TO PAY TO LICENSE THE SUBJECT TRADEMARK.

## Relief from Royalty Method

The RFR method is most applicable when the IP subject to the analysis (the "Subject IP") is an intangible asset that is commonly licensed between two parties—such as trademarks, patents, and copyrights. Ideally, the Subject IP is comparable with IP that has been transacted between third parties, with publicly available licensing agreements or terms. The RFR method is less applicable for certain IP, such as trade secrets, which are not licensed in standardized manners.

The RFR method may pertain to the following scenarios:

- Royalty income that is earned—or could be earned—by the owner of the intangible asset (e.g., a trademark) by licensing the intangible asset to an independent party
- Hypothetical royalty expense that is not paid to an independent party because the owner (1) owns the subject trademark or the right to use the subject trademark and (2) does not have to license it from anyone else

In an RFR method analysis, expected revenue related to the Subject IP may be multiplied by a selected royalty rate to result in royalty income. The expected royalty income for the remainder of the Subject IP's remaining useful life is discounted to the valuation date using a present value discount rate, and the result is the indicated value of the Subject IP.

## Royalty Rate Analysis

The first procedure in the RFR method is typically to estimate a royalty rate that an independent party would be willing to pay to license the subject trademark. This is often described as the arm's-length royalty rate.

The royalty rate may take the form of several different metrics, such as (1) a percentage of revenue, (2) the fixed dollar payments per period, (3) a percentage of gross or net profits, (4) the dollar amount per unit sold, or (5) the dollar amount per unit allocated.

If percentage of revenue is the most applicable metric for the Subject IP, then in an RFR method analysis, expected revenue related to the Subject IP may be multiplied by a selected royalty rate to estimate royalty income. The expected royalty income for the remainder of the Subject IP's remaining useful life is then discounted by the applicable present value factor.

Arm's-length agreements that specify the royalty rate and amount might exist for the Subject IP. These agreements might provide useful insight; however, these transactions may not represent an arm's-length rate applicable for estimating the fair market value or fair value of the Subject IP. Therefore, in the RFR method, the valuation analyst should consider comparable uncontrolled transactions ("CUTs"). An analysis of CUTs provides an indication of what a market participant might pay for the use of the Subject IP.

In an RFR analysis, the CUTs are typically arm's-length licensing agreements in which the payment of royalties (often as a percentage of revenue) were exchanged for the right to use certain IP.

## Comparable Uncontrolled Transactions

There are two types of CUTs: internal and external.

**Table 1**
**Non-Exhaustive Attributes that Affect the Royalty Rate for Intellectual Property**

| Item | Economic Attribute | Positive Influence on Economic Analysis | Negative Influence on Economic Analysis |
|---|---|---|---|
| 1 | Age-absolute | Long-established trademark | Newly created trademark |
| 2 | Age-relative | Older than competing trademarks | Newer than competing trademarks |
| 3 | Use-consistency | Name used consistently on related products and services | Name used inconsistently on unrelated products and services |
| 4 | Use-specificity | Name is general and can be used on a broad range of products and services | Name is specific and can only be used on a narrow range of products and services |
| 5 | Use-geography | Name has wide appeal (e.g., can be used internationally) | Name has narrow appeal (e.g., can be used only locally) |
| 6 | Potential for expansion | Unrestricted ability to use name on new or different products and services | Restricted ability to use name on new or different products and services |
| 7 | Potential for exploitation | Unrestricted ability to license name into new industries and uses | Restricted ability to license name into new industries and uses |
| 8 | Associations | Name associated with positive person, event, location | Name associated with negative person, event, location |
| 9 | Connotations | Name has positive connotations and reputation among consumers | Name has negative connotations and reputation among consumers |
| 10 | Timeliness | Name is perceived as modern | Name is perceived as old-fashioned |
| 11 | Quality | Name is perceived as respectable | Name is perceived as less respectable |
| 12 | Profitability-absolute | Profit margins or investment returns on products and services higher than industry average | Profit margins or investment returns on products and services lower than industry average |
| 13 | Profitability-relative | Profit margins or investment returns on products and services higher than competing names | Profit margins or investment returns on products and services lower than competing names |
| 14 | Expense of promoting | Low cost of advertising, promotion, deals, or other marketing of name | High cost of advertising, promotion, deals, or other marketing of name |
| 15 | Means of promoting | Numerous means available to promote name | Few means available to promote name |
| 16 | Market share-absolute | Products and services have high market share | Products and services have low market share |
| 17 | Market share-relative | Products and services have higher market share than competing names | Products and services have lower market share than competing names |
| 18 | Market potential-absolute | Products and services are in an expanding market | Products and services are in a contracting market |
| 19 | Market potential-relative | Market for products and services expanding faster than competing names | Market for products and services expanding slower than competing names |
| 20 | Name recognition | Name has high recognition (e.g., high aided or unaided recall among consumers) | Name has low recognition (e.g., low aided or unaided recall among consumers) |
| 21 | Industry | Industry revenue is increasing | Industry revenue is decreasing |
| 22 | Stability | Historical positive operating performance | Historical negative operating performance |
| 23 | Leadership | Consistent and effective leadership | Inconsistent and ineffective leadership |

Internal CUTs include an associated enterprise as one of the two parties in the comparable transaction. The associated party may be associated with the owner of the Subject IP or with a prospective licensor or buyer of the Subject IP.

If available, internal CUTs may provide insight into how much the owner received for the use of the Subject IP (or a similar bundle of rights) or how much a prospective licensor or buyer was willing to pay for the use of the Subject IP.

External CUTs involve two unrelated parties. Online databases allow the valuation analyst to search for external CUTs data. These databases include: (1) Business Valuation Resources' ktMINE database, (2) RoyaltySource's Royalty Rates database, and (3) RoyaltyStat, an Exactera company's database.

The valuation analyst can screen database CUTs results using criteria applicable to the Subject IP. Screening criteria may include royalty metric type, date range, geographic region, transaction type, industry, and types of rights granted, among others.

## Comparability with the Subject IP

To ensure that the valuation analyst selects CUTs that are applicable to the Subject IP, the valuation analyst should obtain full agreements from the client (for internal CUTs) or the databases used (for external CUTs). The analyst should use the terms of the CUT agreements and the Subject IP to perform a qualitative analysis of the Subject IP. The terms may affect the comparability of the selected CUTs with the Subject IP.

Some terms in a licensing agreement that may affect the comparability include, but are not limited to:

1. The full bundle of legal rights exchanged in the agreement
2. Expenditures that either party is contractually obligated to pay (e.g., research and development, training, legal costs, etc.)
3. The effective date and termination date of the agreement
4. The ability to sublicense the IP
5. Geographic specificity of the use of the IP

The terms may even require the valuation analyst to adjust the royalty rate to account for any differences between the CUT and the Subject IP—such as when a CUT applies to a broader use of IP or includes additional IP that is not relevant to the Subject IP analysis. For example, if the Subject IP is a trademark and the selected CUT is for the use of a trademark and trade secrets, the valuation analyst may apply an adjustment to the CUT so it is more comparable with the Subject IP. Such an adjustment may be supported by observing purchase price allocation studies for the industry relevant to the Subject IP. Purchase price allocation studies document purchase price allocations recorded by publicly traded companies.

As part of an IP analysis, the valuation analyst should also consider the qualities of the Subject IP and compare those qualities with those of the CUTs. Table 1 (on the previous page) is a non-exhaustive list of attributes that may affect the royalty rate for IP.

After reviewing the selected CUTs and performing a qualitative analysis of the Subject IP, the valuation analyst selects an appropriate arm's-length royalty rate for the Subject IP.

Some licensing agreements include a step-up or step-down in the royalty rate after a stated period (typically when the IP is being used in a new market). An analyst may consider applying a similar royalty rate adjustment in an RFR analysis.

## Projection Analysis

The income measure of the RFR method is typically after-tax royalty income. In the RFR method, the periodic after-tax royalty income is typically dependent on (1) revenue, (2) the arm's-length royalty rate, and (3) the applicable income tax rate. The valuation analyst also must consider the time period relevant to the Subject IP: What length of time is relevant to the royalty income? What is the frequency of royalty income?

Unlike a going-concern business, IP often has a limited life. Therefore, the projection time period in an RFR analysis should be limited to the remaining useful life of the IP.

The frequency of royalty income is also a key component in an RFR analysis. Valuation analysts often default to applying an RFR analysis to annual income projections

because business managers often develop projections annually. However, adjustments can be made to the present value discount factor to address the fact that royalty income may be generated throughout the year, rather than at one point in time. In circumstances where income is expected to vary significantly in different periods (such as quarters or months), shorter frequencies may be more applicable.

Annual revenue projections may be developed by the valuation analyst and the owner or prospective user of the Subject IP. The revenue projection development process is a critical step in the RFR method that requires significant attention from the valuation analyst. Projections are often vulnerable to the behavioral biases of the projection developer. Therefore, a comprehensive understanding of economic-, industry-, and company-specific factors is necessary to vet or develop reliable revenue projections. In addition, an analyst may apply quantitative models based on the historical performance of the Subject IP or comparable IP to assess the reasonableness of the revenue projections.

As soon as the revenue projections are considered to be reasonable, the valuation analyst applies the appropriate arm's-length rate to the projected revenue attributable to the Subject IP. This results in pretax royalty income. The effective or prospective tax rate relevant to the Subject IP royalty income is applied to derive after-tax royalty income.

The next step in the RFR analysis is to estimate the appropriate present value discount rate to apply to the Subject IP after-tax royalty income.

## Present Value Discount Rate

The present value discount rate converts the IP income into an estimate of value. The discount rate is the risk-adjusted rate of return that is required to induce an investment in the IP during the specified time period (often the remaining useful life of the asset).

A comprehensive discussion of present value discount rates is beyond the scope of this article. However, the key considerations are as follows:

1. Market Equivalency – The present value discount rate should be derived from market data to the extent possible.
2. Associated Risk – The risk associated with the owner of the IP achieving the after-tax royalty income should be reflected in the present value discount rate.
3. Income Measure Consistency – The income measure applied in the projection analysis should be consistent with the present value discount rate.
4. Forward Looking – The present value discount rate should consider the prospective nature of the income, rather than the historical rate of return.
5. Time Period Consistency – The present value discount rate should be consistent with the term and frequency of the prospective royalty-derived IP income.

The RFR method value indication is derived after applying the selected present value discount rate to the projected after-tax royalty income.

AS SOON AS THE REVENUE PROJECTIONS ARE CONSIDERED TO BE REASONABLE, THE VALUATION ANALYST APPLIES THE APPROPRIATE ARM'S-LENGTH RATE TO THE PROJECTED REVENUE ATTRIBUTABLE TO THE SUBJECT IP.

## RFR Method in Action

Consider the following simplified example. The Candy Company ("Candy") is the manufacturer and distributor of candy and confectionary products. Candy sells certain products using a trademarked brand (the "Sweets Trademark"). Candy is considering the sale of the Sweets Trademark to a third party. To better understand the value of the Sweets Trademark, Candy retains a valuation analyst to provide an estimate.

In this case, the valuation analyst concludes that the

**Table 2**
**Candy Company Sweets Trademark**
**Valuation Summary**

| | Projected Fiscal Years Ending December 31, | | | | |
|---|---|---|---|---|---|
| | 2025 | 2026 | 2027 | 2028 | 2029 |
| Valuation Analysis | $000 | $000 | $000 | $000 | $000 |
| Projected Revenue Attributable to Intellectual Property | 10,000 | 10,200 | 10,404 | 10,612 | 10,824 |
| Arm's-Length Royalty Rate | 5.0% | 5.0% | 5.0% | 5.0% | 5.0% |
| Pretax Royalty Payments Avoided | 500 | 510 | 520 | 531 | 541 |
| Income Taxes (25%) | 125 | 128 | 130 | 133 | 135 |
| After-Tax Royalty Payments Avoided | 375 | 383 | 390 | 398 | 406 |
| Present Value Factor (10%) | 0.9091 | 0.8264 | 0.8264 | 0.6830 | 0.6209 |
| Present Value of Royalty Payments Avoided | 341 | 316 | 322 | 272 | 252 |
| Total Present Value of Royalty Payments Avoided | 1,503 | | | | |
| Fair Value of the Sweets Trademark (rounded) | 1,500 | | | | |

Sweets Trademark is a commonly licensed form of IP and that other businesses in the candy and confectionary products industry have partaken in comparable transactions. Therefore, the valuation analyst concludes that the RFR method is an appropriate method for estimating the value of the Sweets Trademark.

The valuation analyst interviews members of Candy management to understand the characteristics and factors that affect the use of the Sweets Trademark. After reviewing economic attributes of the Sweets Trademark, the valuation analyst concludes that the Sweets Trademark includes trademarks, logos, and symbols owned by Candy; and the Sweets Trademark can only be used in relation to candy products in the U.S. Through interviews, the analyst also learns that Candy management expects to replace the Sweets Trademark in five years. Additionally, the valuation analyst concludes that the candy and confectionary industry is in a mature stage and expects modest industrywide revenue growth.

After performing a qualitative analysis, the valuation analyst uses research databases to produce transactions of similar trademarks. Based on the analyst's screening parameters, the databases return 20 uncontrolled transactions. The analyst reviews the terms for each of the 20 transactions and finds that 2 of the transactions are at least 20 years old. The analyst removes these transactions from the pool because their age relative to the Sweets Trademark makes them less comparable. The analyst also finds that 3 of the 18 remaining transactions are related to candy manufacturing equipment, rather than candy products, and are thus less comparable with the Sweets Trademark. As a result, the analyst selects 15 of the 20 transactions as CUTs.

The median royalty rate of the 15 selected CUTs is found to be 5.0 percent of revenue. Due to similarities between the CUTs and the Sweets Trademark, including (1) age, (2) use geography, and (3) growth potential, the valuation analyst concludes the CUTs median to be the best estimate for the arm's-length royalty rate relevant to the Sweets Trademark.

The valuation analyst then collaborates with Candy management to develop projections for future revenue attributable to the Sweets Trademark. Based on historical and stabilized revenue performance, the valuation analyst expects revenue attributable to the Sweets Trademark during 2025 to be $10.0 million. Based on the modest growth expectations for the industry and Candy management's expectations for the Sweets Trademark, revenue is estimated to increase 2.0 percent annually throughout the remaining useful life of the Sweets Trademark.

Applying a 5.0 percent royalty rate to the expected future revenue attributable to the Sweets Trademark results in the pretax royalty payments avoided. The valuation analyst then applies the appropriate income tax rate, based on Candy management expectations, to this amount.

Based on (1) relevant cost of capital data, (2) the Candy cost of capital, and (3) the risks specific to the Sweets Trademark, the valuation analyst estimates 10 percent as the after-tax present value discount rate to apply to the after-tax royalty payments avoided. The analyst then sums the results to arrive at an indication of value for the Sweets Trademark.

Depending on the purpose of the assignment, the valuation analyst might have to incorporate a tax amortization benefit ("TAB") associated with the subject IP. In the taxable acquisition of certain intangible assets, the buyer can amortize the tax shield created by the amortization of the subject IP over a statutory period (often 15 years).

The TAB incorporates this tax shield into the value of the subject IP. For example, the TAB often is applied if the subject IP is part of a taxable business combination under the Financial Accounting Standards Board's Accounting Standards Codification Topic 805. However, the valuation analyst finds a TAB is not applicable in the analysis of the Sweets Trademark.

The RFR method example is presented in Table 2 on the preceding page.

## Summary

RFR method analyses may be relied on for IP transactions of significant economic importance that are likely to face close scrutiny. Therefore, it is important for valuation analysts to conduct thorough and well-documented RFR method analyses when the RFR method is applied in IP valuations.

A thorough application of the RFR method requires (1) qualitative analysis of the economic attributes of the subject IP (2) thoughtful selection of CUTs when estimating an arm's-length royalty rate, (3) reasonable projections of royalty income, and (4) a market-based present value discount rate.

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