

# Valuation of Trade Secrets

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# The Challenge

Trade Secret Valuation

# Trade Secret Valuation Challenges

**Defining the Subject Asset:** A process, know-how, formulas, test results, other? A single asset or portfolio of unique assets?

**Each Asset is Unique:** does not qualify as a trade secret if commonly known – must be unique to the owner

**Will not be Bought and Sold:** Limited ownership rights, thus transfer without other assets is difficult. Process of due diligence would unveil secrets.

**IP and Cash Flow:** How does an intangible asset contribute to its owner's financial performance? What portion of profits are due to the asset?

**Context:** Common context for trade secret valuation is litigation – must explain complex concepts and analysis to judge and jury

# Defining and Identifying Trade Secrets

**Definition:** “Information, including a formula, pattern, compilation, program, device, method, technique, or process that: derives economic value from not being known to the public; and is subject to efforts to maintain its secrecy.” – *Uniform Trade Secrets Act*

**Defend Trade Secret Act (USA DTSA)** The trade secret owner is entitled to recover its actual loss. The trade secret owner may also recover any unjust enrichment caused by the misappropriation that is not adequately compensated by its actual loss. Alternatively, the trade secret owner may recover a reasonable royalty for the unauthorized disclosure or use of the trade secret

## **Value & Damages based on economic advantage:**

- Head Start: benefit achieved by infringer when use of Trade Secrets gave the infringer a “head start.” Value of business with v. without ‘head start’
- Saved Development Costs: Quantify R&D expense avoided

# Defining and Identifying Trade Secrets

## Criteria to Qualify as Trade Secret

- ✓ The information is not known outside of the company that owns/claims the trade secrets
- ✓ Information provides economic benefit (value) to its owner
- ✓ Owner has invested in development of the asset
- ✓ Information is known by employees and others at the business to a limited extent
- ✓ Information could not be easily acquired or duplicated by others
- ✓ Owners have undertaken measures to protect the secrecy of the information

# Challenge: Applying Valuation Approaches

**Assignment:** tech company alleges competitor is using its trade secrets, how has the Company been harmed

Approach	Standard Methodologies	Applicability
<b>Cost</b>	Cost to replace or replicate <ul style="list-style-type: none"><li>• Past investments</li><li>• Cost of achieving awareness (RfPPC)</li></ul>	Context is not financial reporting Provides a minimum indication of “worth”
<b>Market</b>	Study of transactions <ul style="list-style-type: none"><li>• Guideline companies</li><li>• Guideline transactions</li><li>• Industry benchmarks</li></ul>	Few trade secrets bought or sold without other assets, no useful guideline transaction data Does not address the question: what is the benefit to current business
<b>Income</b>	Present Value (PV) of future benefits <ul style="list-style-type: none"><li>• Relief from Royalty (RfR)</li><li>• Discounted cash flows (DCF)</li></ul>	Decline in financial performance at Company, and/or Increase in performance at Competitor Hypothetical license

The Challenge

# Applying IP Valuation to Trade Secrets

# IP Valuation Basics

*Trade Secret Valuation is essentially IP Valuation – similar considerations*

## Business Valuation

$$Valuation = \sum_{t=1}^n \frac{CF_t}{(1 + DF)^t}$$

Calculation is based on 100% of cash flows

Discount factor is based on cost of capital

## IP Valuation

$$Valuation = \sum_{t=1}^n \frac{X\% \text{ of } CF_t}{(1 + RR)^t}$$

Calculation is based on X% of product cash flows

Discount factor is based on the required return for trade secret assets (extra risk?)

- 1. IP (and T/S) depends on other things to generate earnings***
- 2. Must define the IP to analyze it. Must qualify and define the T/S***
- 3. Must quantify how Asset contributes to financial performance***
- 4. One more step compared to business valuation – apportion cash flows***

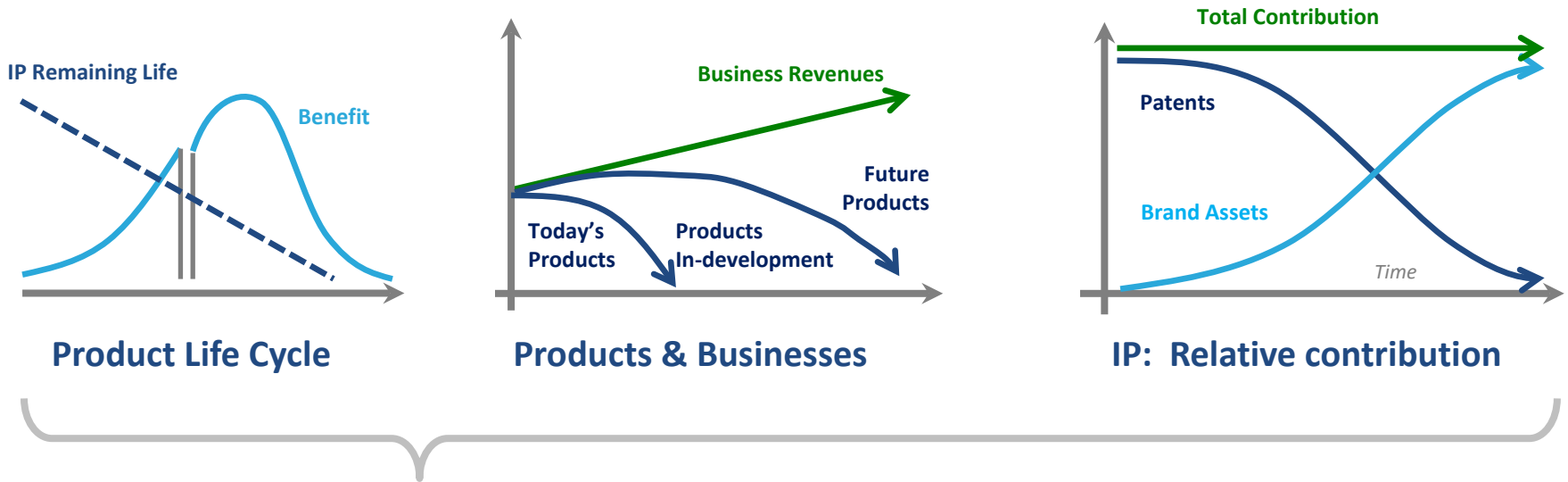


# How IP Contributes to Value

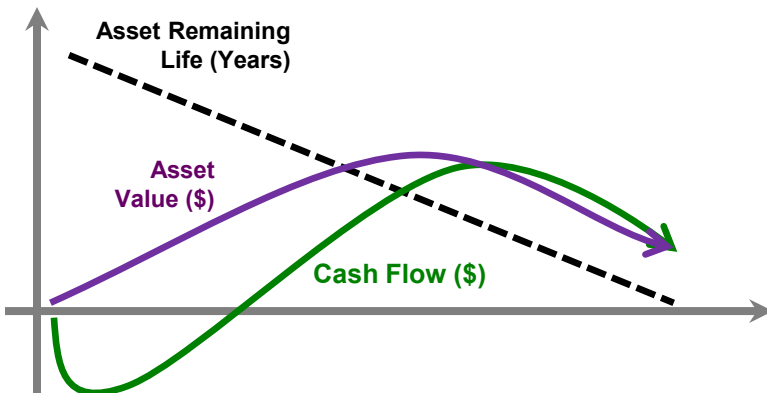
<b><i>Exclusive Use</i></b>	Exclude others from using (not a monopoly grant)	<ul style="list-style-type: none"> <li>• Pricing power</li> <li>• Greater sales volume</li> <li>• Cost Savings</li> <li>• Faster to market (Time value of \$)</li> </ul>
<b><i>Litigation</i></b>	Seek damages if others use	<ul style="list-style-type: none"> <li>• Litigation award (PV of award less costs)</li> <li>• Threat of litigation (force “Monopoly” or “Permission”)</li> </ul>
<b><i>Permission</i></b>	<del>Ability to be compensated when others use</del>	<ul style="list-style-type: none"> <li><del>• Value of license (PV of royalties+fees—costs)</del></li> <li><del>• Value if sold</del></li> </ul>
<b><i>Promotion</i></b>	Signals innovation, uniqueness, source of origin to consumers	<ul style="list-style-type: none"> <li>• Additional sales</li> <li>• Contribution to branding / Reduced marketing</li> </ul>

***Value is Derived From the Economic Benefits Created***

# Forecasting Future Benefits



## IP: Remaining Life, Cash Flow & Value

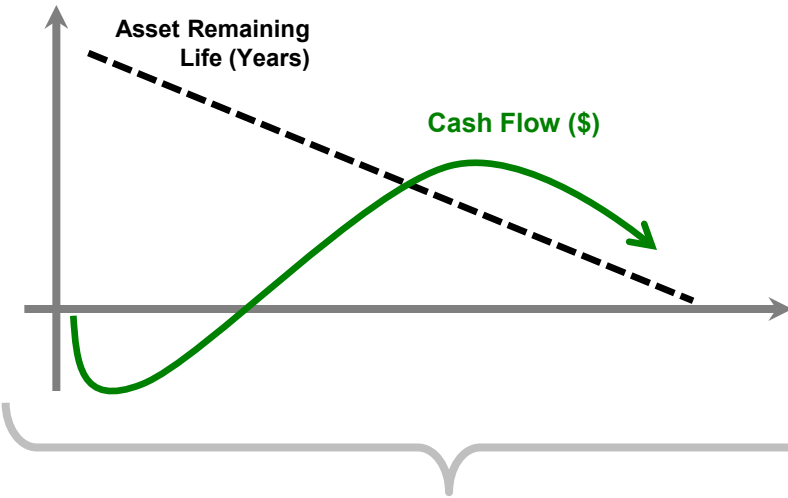


## Guiding Concepts

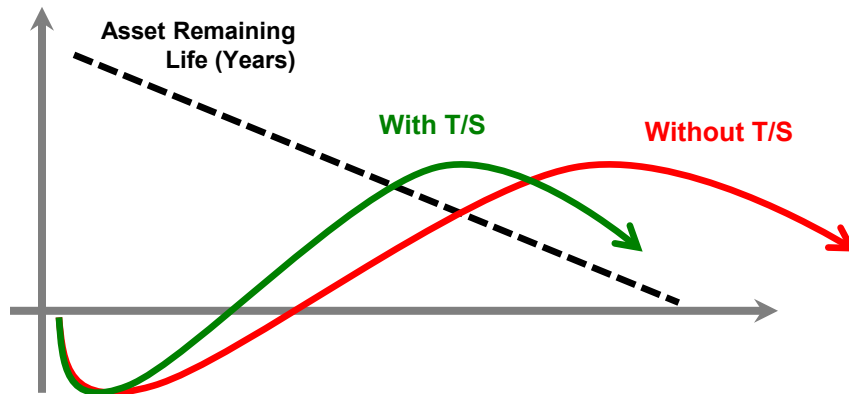
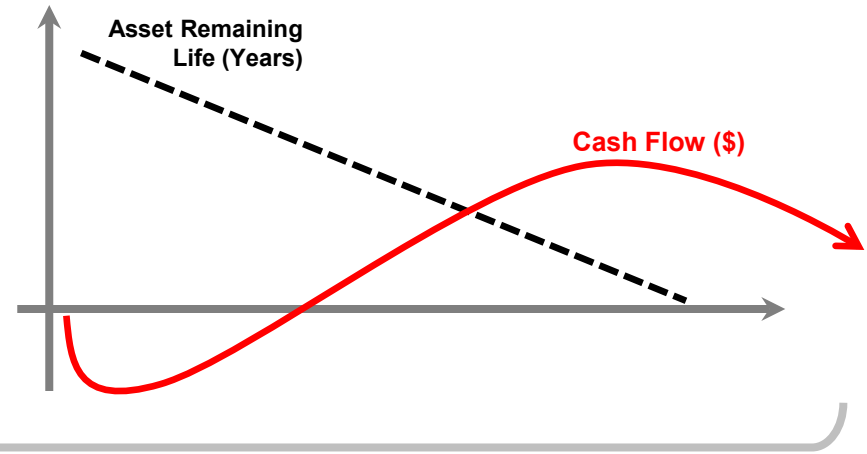
- IP and the products that use IP have life spans
- Companies can expect perpetual growth, IP cannot
- Benefits from the IP will grow, peak and then decline as other IP and other products take their place

# Head Start Forecasts

## IP Cash Flows With Trade Secret



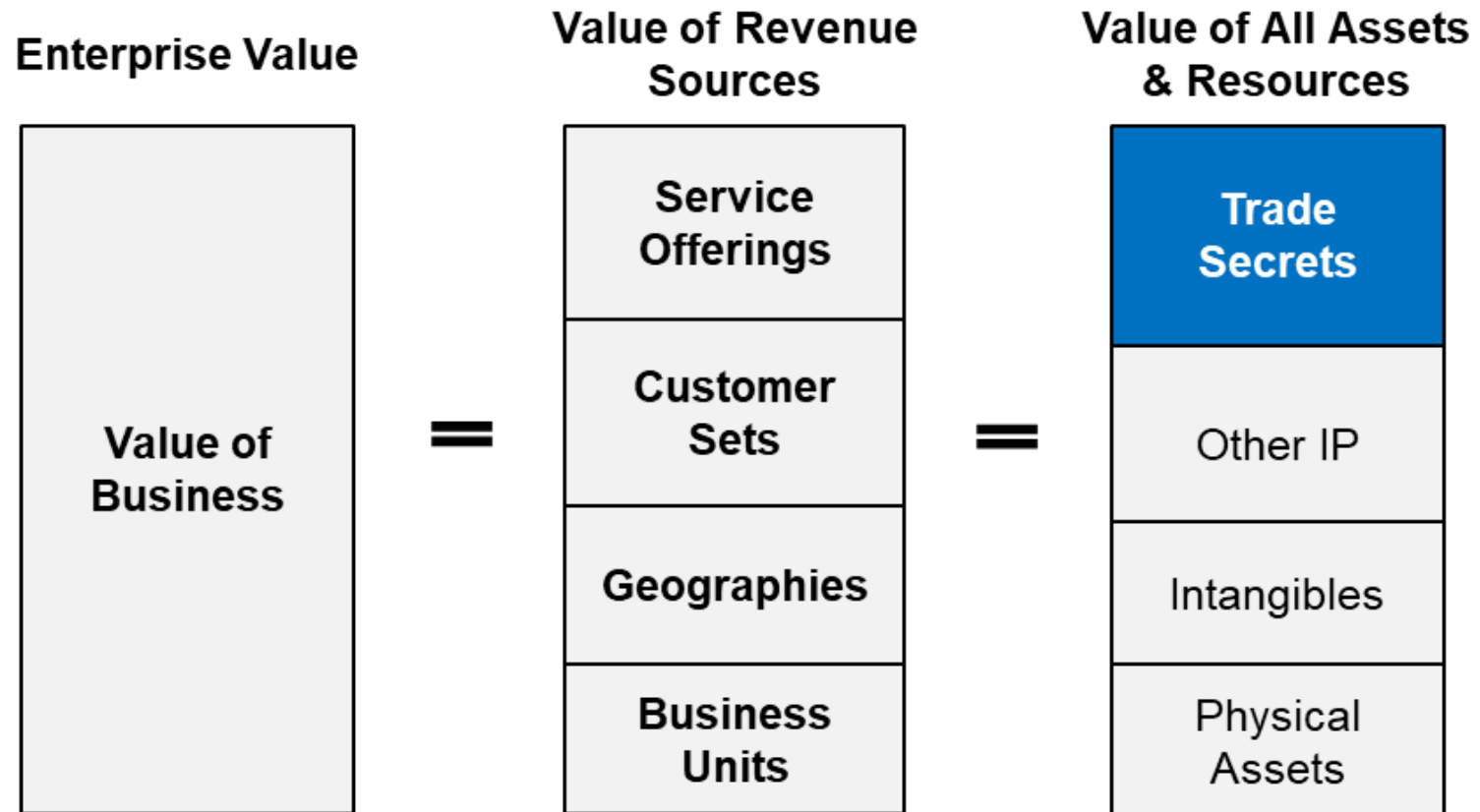
## IP Cash Flows Without Trade Secret



- Infringer Saved Time – Damages based on difference in Value of the two forecasts
- **Beware:** this type of forecasting can become speculative quickly

# Apportionment Framework

Any IP Asset depends on other assets and resources to generate economic benefits



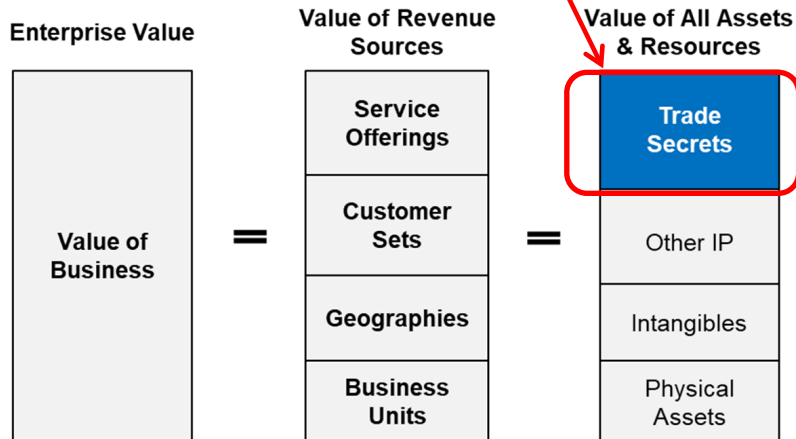
**Apportionment:** Identify the portion of future economic benefits derived from use of each asset or resource

# Challenge: Apportion Earnings to the Brand

*How is our Brand contributing to our performance?*

## Apportionment Framework

*What is the value of this box?*



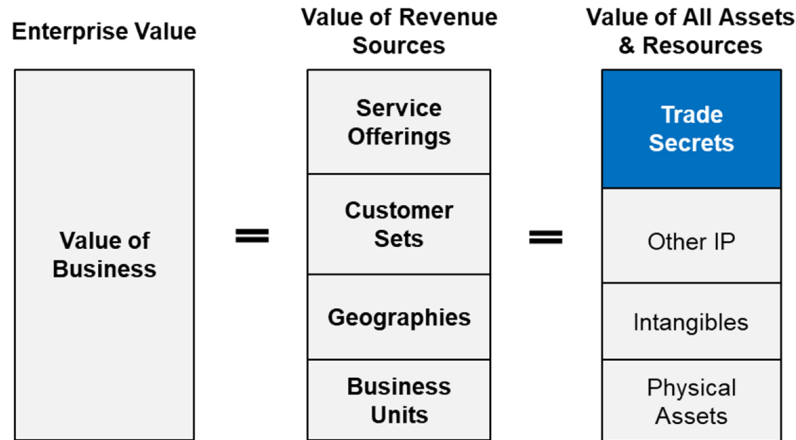
## Tools to Apportion Economic Benefits

- Website Analytics
- Social Media Analysis
- Brand Score
- Brand Equity Models
- Company Language Analysis
- Compare profitability / Excess profits (“CPM”)
- Surveys / Interviews /Focus Groups
- Apportionment Matrix

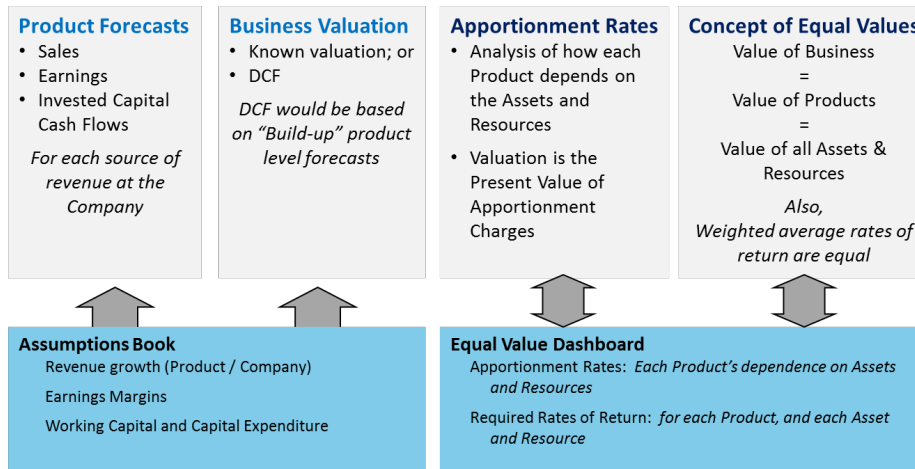
*Use as many tools as feasible*

# Brand Valuation Apportionment Model

## Applies the Apportionment Framework



## Framework of the Model

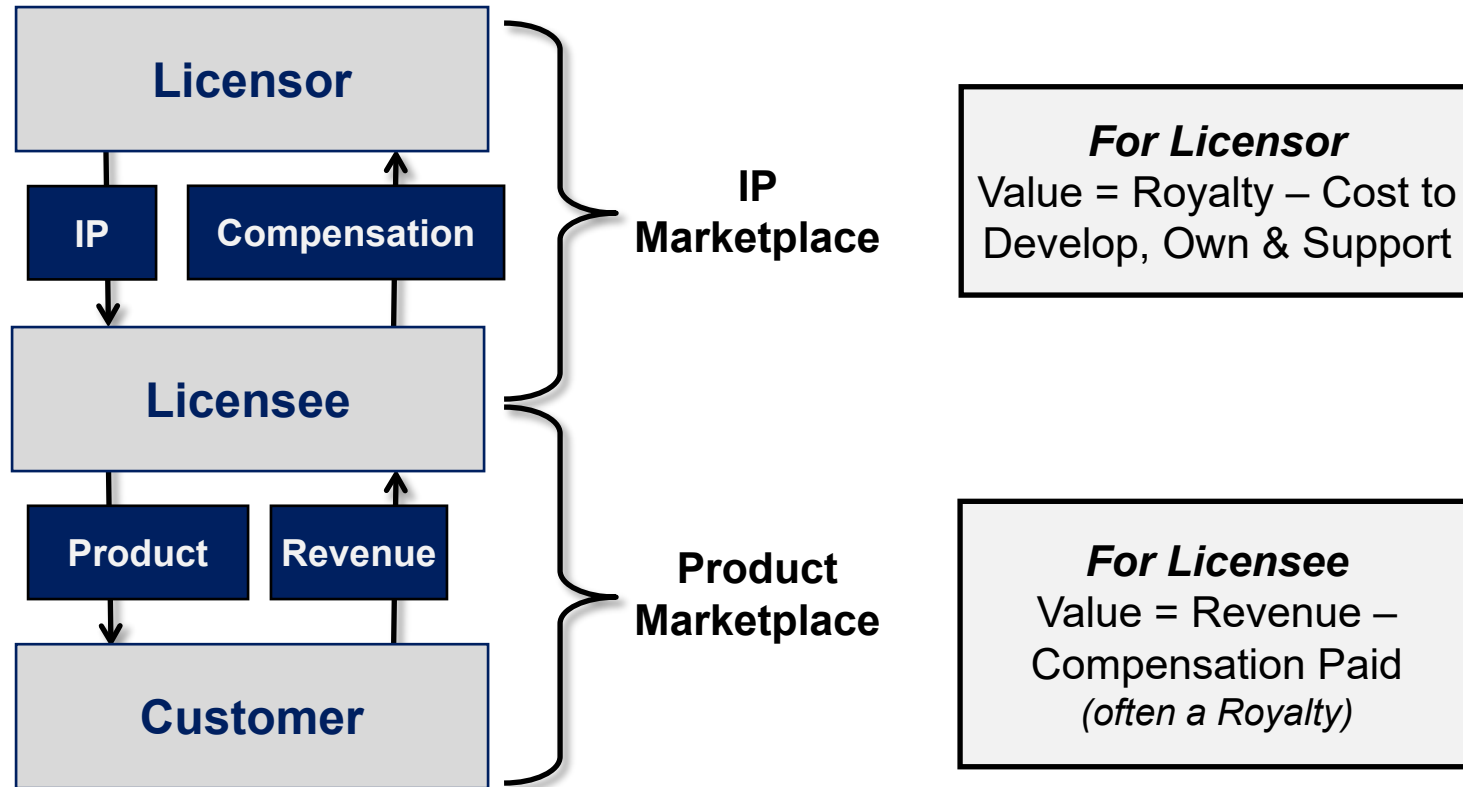


## 6 Step Process

1. Determine Enterprise Value
2. Forecast each source of revenue (Products & Services)
3. Identify Key Assets & Resources (Apportionment Matrix)
4. Develop Apportionment Rates
5. Value the Apportioned Forecast Cash Flows
6. Apply concept of Equal Values

# Valuation Using a Licensing Framework

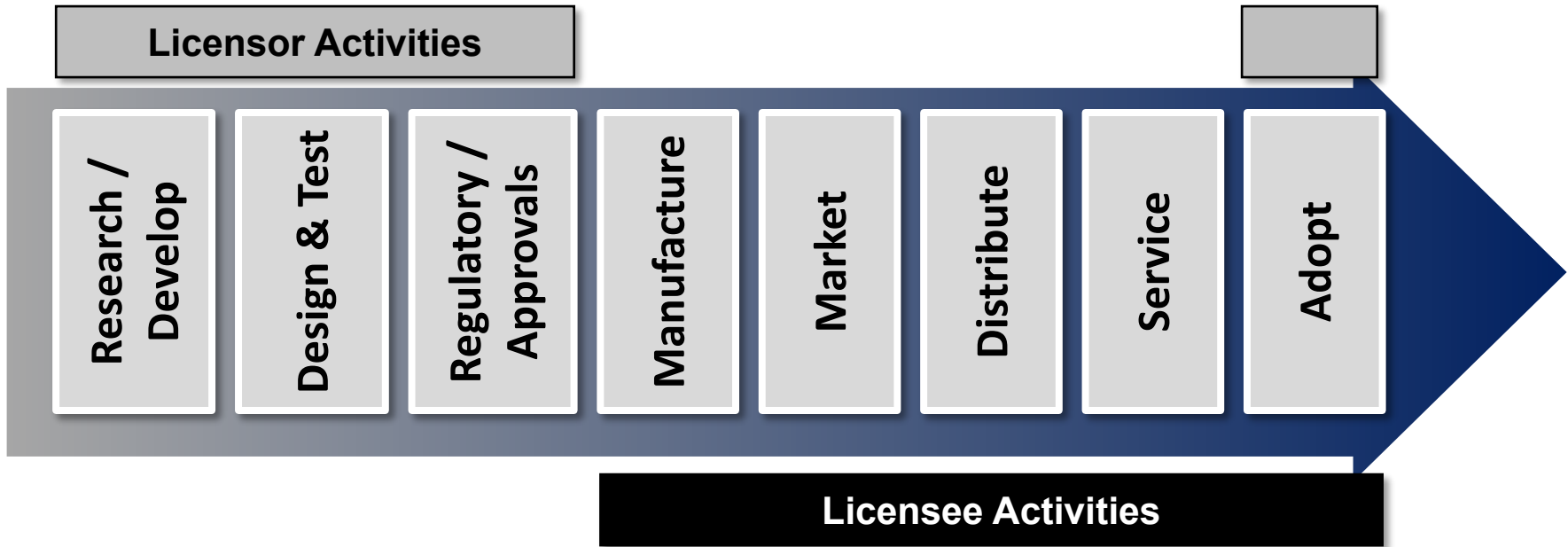
## *The Relief from Royalty Methodology*



*Transaction requires benefit for multiple parties*

# Licensing is Sharing

## *The Relief from Royalty Methodology*



*Hypothetical License Context requires an understanding of shared responsibilities*



# Challenge: Royalty Base and Comparable Rates

## Level of Benefit Drives the Royalty

Best for Licensor

Financial Risk to Licensee

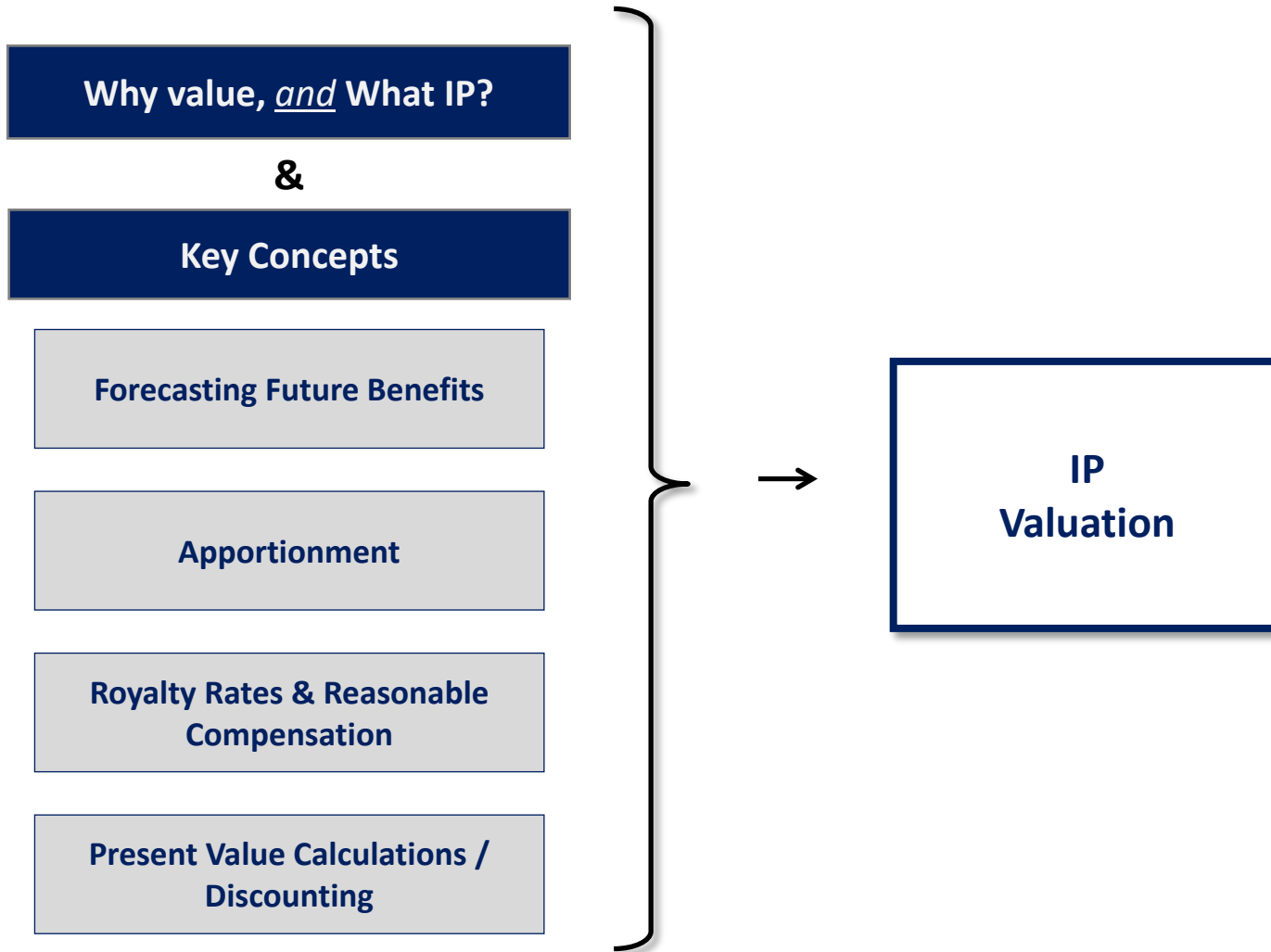
**\$ / Unit made**  
**\$ / Unit Sold**  
**Gross Sales (\$ invoiced)**  
**Gross Sales (Collections)**  
**Net Sales**  
**Gross Profits**  
**EBIT**  
**Net Profits**

Best for Licensee

Income Statement		
<b>Revenues</b>		
Gross Sales	1,000	100%
Discounts	5	1%
<b>Net Revenue</b>	995	100%
<b>Operating Expenses</b>		
Cost of Sales	450	45%
<b>Gross Profit</b>	545	55%
<b>Operating Expenses</b>		
Sales & Marketing	100	10%
General & Admin	75	8%
Research & Development	50	5%
Depreciation	35	4%
Other	15	2%
<b>Total OpEx</b>	275	28%
<b>Operating Income</b>	270	27%
<b>Other Income / (Expense)</b>		
Interest, net	(55)	-6%
Non-recurring	(45)	-5%
Sale fo Assets	85	9%
<b>Total Other Income</b>	(15)	-2%
<b>Pre-tax Income</b>	285	29%
Tax Expense	(100)	-10%
<b>Net Profit</b>	185	19%

*Not all royalties are the same*

# Bringing it all Together



# Thank You

## Expert Testimony & Infringement Investigations

**Trial Tested Experts** whose opinions are accepted in Federal & State courts, US Tax Court, Arbitration and Mediation proceedings

**Published** thought leaders in IP Analysis

**Damages Calculations** and opinions for cases involving: patent infringement, Lanham Act, Copyright Act, trade secret infringement, defamation, tax, business partnership and start-up financing disputes

## IP Valuation & Strategies

**Valuation** of IP, proprietary assets and businesses for tax and transfer pricing, financial reporting and strategic planning

**Strategic IP Advice** for boards, executives and investors on IP monetization, optimal pricing, and marketing and branding strategies

**Due Diligence** supporting asset transfer, licensing and brand extension transactions for buyers, sellers, licensors and licensees



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# Extra Slides

# Apportionment Valuation: Sample Results

## Assignment: Value Name, Brand, IP and Intangibles at Tech Company

Value of Business		Value of Assets & Resources				Value of Revenue Sources			
		Asset / Resource	Rate of Return	Valuation	Value Contribution		Rate of Return	Valuation	Value Contribution
		Working Capital	5%	153	19%	Product A	20%	46.7	6%
		PP&E	8%	209	26%	Product B	14%	602.8	74%
		Brand Assets	12%	168	21%	Service C	19%	169.0	21%
		Patents	14%	134	16%				
		Proprietary Software	17%	66	8%				
		Trade Secrets	20%	8	1%				
		Relations with Customers	21%	100	12%				
		Relations with Suppliers	20%	49	6%				
		Workforce	23%	28	3%				
		Unidentified / Synergies	29%	-97	-12%				
WACC	15%	Weighted Return			10%	Weighted Return			15%
<b>Business Value</b>	<b>819</b>	<b>Total Value</b>		<b>819</b>		<b>Total Value</b>		<b>819</b>	

Apportionment Rates				IP Expense Allocation	
Asset / Resource	Product A	Product B	Service C	Asset / Resource	IP Expense
Working Capital	3%	3%	3%	Brand Assets	35%
PP&E	10%	10%	10%	Proprietary Technologies	30%
Brand Assets	25%	12%	30%	Marketing Content	10%
Patents	25%	10%	30%	Trade Secrets	25%
Proprietary Software	10%	25%	2%		
Trade Secrets	5%	5%	2%		
Relations with Customers	10%	15%	20%		
Relations with Suppliers	5%	10%	2%		
Workforce	7%	10%	1%		
	<b>100%</b>	<b>100%</b>	<b>100%</b>		<b>100%</b>

# Relief from Royalty Example

Period	0	1	2	3	4	5
Forecast Licensee Sales	<b>1,000</b>	<b>1,300</b>	<b>1,495</b>	<b>1,645</b>	<b>1,727</b>	<b>1,761</b>
Growth Rate		30%	15%	10%	5%	2%
Annual Royalty Rate		<b>8%</b>	<b>8%</b>	<b>8%</b>	<b>8%</b>	<b>8%</b>

## For IP User (Licensee)

Up-front payment	(50)					
Annual Fee		(5)	(5)	(5)	(5)	(5)
Additional Profit Margin		15%	20%	15%	10%	5%
Additional Profits	-	195	299	247	173	88
% of Sales Royalty	-	(104)	(120)	(132)	(138)	(141)
Total Benefits	(50)	86	174	110	30	(58)
Present Value @ 25%	(50)	69	112	56	12	(19)
Value of IP to Licensee	<b>180</b>					

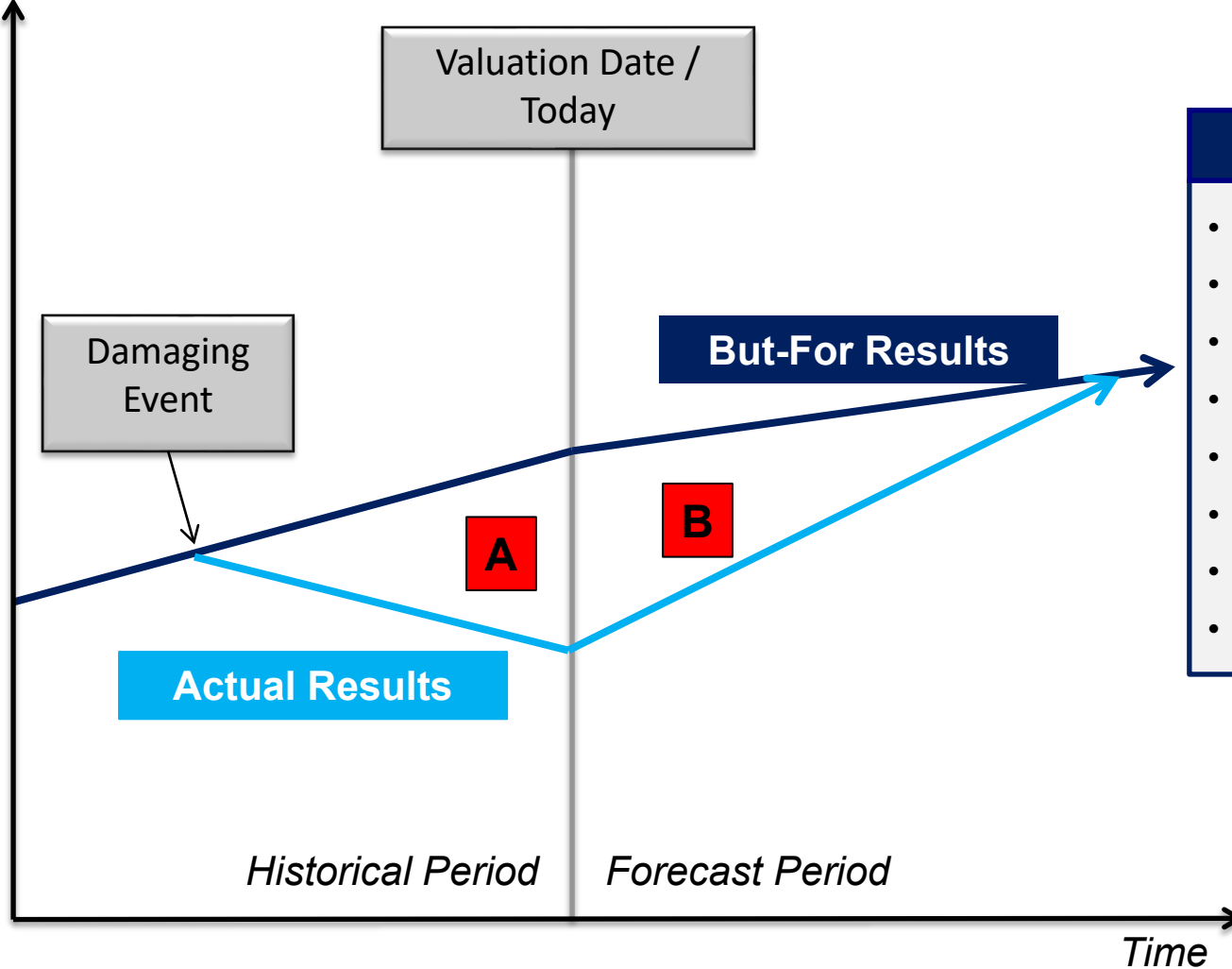
## For IP Owner (Licensor)

Up-front payment	50					
Promotions Commitment		(130)	(150)	(82)	-	-
Promotions Commitment %		10%	10%	5%	0%	0%
Annual Fee		5	5	5	5	5
% of Sales Royalty		104	120	132	138	141
Total Benefits	50	(21)	(25)	54	143	146
Present Value @ 20%	50	(18)	(17)	31	69	59
Value of IP to Licensor	<b>174</b>					

- ✓ Forecast required
- ✓ Constant or variable rate?
- ✓ Non-royalty compensation (fees, marketing, minimums)
- ✓ Typical RfR Calculation only includes forecast for Licensor

# Lost Profits: But-For v. Actual

Economic Benefits



## Building Benefit Forecasts

- Market outlook
- Economic trends
- Peer group analysis
- Competitive product analysis
- Pricing and discounting history
- Pricing strategy
- Share of product portfolio
- Product life cycle stage