How much will buyers or licensees pay?

The answer is as much as you prove it is worth to them…..

Last Thursday night, as a favour to one of the members in my online INVENTORS MASTERMIND group in FaceBook, I jumped on a conference call with him, to initiate trade-sale or licensing talks with a North-American prospective buyer, who happened to be the manufacturer of a range of products my client distributed for them exclusively in Australia.

John (his real name) needed to justify a sensible price for his IP and was stuck on the only valuation method he understood – what it cost him to build it. We talked about other methods and I shared with him the 5P model for maximising IP value for licensing or trade-sale agreements.

Some years ago, John had identified a need for a product that would optimise the current range of products he was importing and distributing across Australia. He was convinced this new technology would help make this existing range of products more competitive, in technology, reliability and price. His "black box" device eliminated the need for this very expensive 16-core copper cable in between the units (one site has 11 kilometres of this stuff – at $8.00 per metre!) and understandably, the users fully understood they could save on price, shipping costs, installation and maintenance - if all that cable wasn't required.

We had to build a case for why the manufacturer needed to acquire this IP for their range. We did our research well before we got on the phone to speak with them.

Firstly, we identified that they were wholly-owned by a publically-listed Company, with approximately 40% of that stock being owned by a private equity firm. This was all good news for John, because we could ultimately negotiate a cashless transaction, by simply swapping the equity in his R&D company for shares in the public company.

This means the transaction doesn't affect cashflow or the profit and loss statement of the buyer and where the inventor operates in a tax regime that features capital gains taxes, he may be able to forego these gains until the moment he liquidates the new shares he has acquired.

Private equity firms understand the value of a cashless transaction and don't mind the slight dilution for adding a cash-generating asset to the portfolio. It's an easy win for them. To structure this in the most attractive way, we applied the 5P pricing formula for licensing/trade sale negotiations. Here's how it works

Pricing

The first stage of winning the best price possible is to build a value model from the perspective of the prospective buyer. Some of the questions you need to ask yourself include:

- What could the buyers sell these units for?
- What could they produce them for (given they will have better economies of scale that you)?
- Can they access the resources and facilities to produce these?
- Is the competitive advantage less for national and even global exclusivity, than for local exclusivity? (it might be more efficient to segment the licensing or trade sale to a territory and negotiate multiple licensing agreements)
- Could this make their existing offer more competitive?
- How many of these units could this buyer go back and immediately offer to their existing or past customers? (easy sales, plus reengagement)
- Could this be used to get them new customers? (Can we calculate the value of each new customer?)
- Could they use this innovation to take customers from their competitors? (by promoting their "complete package" as a new market positioning)
- Could they take distributors from their competitors' networks? Surely most of the competitors distributors will hate to lose sales because they do not have access to something that ultimately might be featured in the eventual tender. (This would surely shift or enhance the existing Industry dominance).

This assessment becomes the first qualifier for who should buy the technology or licence. If you can present the business case (for acquiring this technology) from their perspective, you might later overcome one of the greatest stumbling blocks in the process – getting to the right decision-maker. Sometimes, you cannot get in front of the right decision-maker and if your contact presents the idea armed with nothing but enthusiasm, it might get shot down before you get started.

Perspective

The second stage to valuing the asset is to measure their opportunity cost of DIY. How much labour would it take for the prospective buyer to do this themselves and how many months/years could it be achieved in? Is this less than what the current product could be established in the market for? They need to be reminded that if they didn't buy this, who would and what would that do to their cashflow, if their competitor had the advantage? The answers to these questions can be modelled and measured by a good accountant.

Modelling this option becomes critical if you are not present during the discussions. You cannot expect to have everyone in their evaluation team to be positive about this acquisition, so building the rebuttals to un-declared arguments could help those more enthusiastic advocates to justify their position with cold, financial logic.

Paperwork

The third phase is compiling the due diligence file. This means sourcing as much external information and secondary reports from unrelated sources, that support the conclusions you made in phase 1. For John, this meant taking a large, international tender which he bid for (and didn't win) with the manufacturer's equipment, and show how much more competitive they could have been with this device.

It was easy to identify a saving on this one project, of nearly $250,000 in removing redundant equipment, the reduction in installation costs and the price of 5-years maintenance (which was part of the tender). Having an actual tender document restructured using this technology, immediately showed how they could overcome the first issue in most tenders – price.

Without stating the obvious, this will also show the prospect just how much cheaper and more efficient their competitors could be, if these decision-makers pass on this project and the competition takes up the option.

The Players

The final phase is to get a better understanding of with whom you are going to be dealing. We profiled the key personnel within the target company and we researched the ownership up 2 levels. We understood this could go well beyond the pay-grade of the local management and we didn't want to worry if they had the skills to present a winnable business case. They made it very clear they wanted this, but we know it was going to be up to us to help them get this done.

Before we offered this product to them, we asked them if we could help their distributors become more competitive by letting them know we had these new units available. They agreed and provided us with a list of their global distributors. We were able to write to these distributors and introduce ourselves as part of their global network,

As part of this marketing program, we gave each distributor an opportunity to receive a pair of these units to evaluate. They had the option to return these within a few months or simply pay the accompanying invoice and on-sell them into their next project. There was little risk because of the longstanding relationship they each had with the manufacturer.

By the time we got to the negotiating table, we had a persuasive argument for why the prospect needed this to remain competitive in a technology-evolving environment. We knew the people who would be seated across from us and we knew the people they would have to present this business case to.

We had prepared an encompassing presentation on the technology and the business case for acquiring it, as well as a detailed expansion of the "do nothing" option. As this industry was considered a duopoly, we knew we could play to their fears of their larger competitor being able to access this and use it in the same way we proposed they used it on them.

We made it understood that they had the first option, that if they passed they knew where it would be presented next and finally (and very importantly) they understood that the decision for taking it to competitors was not John's. This took all pressure off John for the duration of the negotiations (the technique is known as "vague higher authority").

Payment Options

Pricing the intellectual property was easy for us, because we had experience in this area. For the novice, this is the hardest option and can result in selling out too cheaply or not getting a deal because of affordability. On the affordability issue, we asked ourselves one question:

What if the buyer could acquire the technology for no cash at all?

Our research had identified two important facts. The first was that 100% of the shares in this manufacturer were owned by a publically-listed Company. The second fact was that this publically-listed company was 40% owned by a private equity firm. This was good news from the level of sophistication we could apply to this deal, but bad news from the perspective of how experienced and powerful the negotiations would be.

This simply meant John would need someone experienced in his corner and he already knew he had someone talented and experienced to turn to….. me.

We structured a deal which would enable the listed parent company to issue equity in the main company to the value of the price we had decided was fair and justifiable. These shares would be tradeable and would be ordinary shares with all entitlements (no special class of shares).

The transaction was absolute in its structure, but gave the vendor a buy-back option for a fixed price, if for any reason the shares in the Company dropped more than 30% or were suspended. The buy-back included a “first-right of refusal” (at equally-favourable terms) for any trade-sale of that technology to a third party. We tried also to negotiate in a 5% share of any licensing agreements the buyer did, within the first 5 years of ownership, but this became a concession that was negotiated out in the process.

To make the deal even more attractive, we had a sceptics’ option. This allows the buyer to be absolutely certain the project is a good one, by reducing the initial issue of shares by 25% and offering a further 60% of options in the Company, exercisable at the current 90-day average price. This ensured the vendor could not benefit from the entire sale price, unless the Company share value increased. This would be inevitable, given the value of the technology.

There are risks associated with a sceptics’ option. The Company circumstances might change for reasons other than the project and this will affect the options value. The Company might sell or trade the technology to a third party and offset the transaction price for debt or some non-cash asset, which might not complement the share value.

The underlying assumption one has to make is that Directors will work to increasing the share value for all shareholders, as part of their fiduciary obligations. Most of the time you can review the published audited accounts with the relevant stock exchange to know how risky this option can become.

Conclusion

Because the ink isn’t totally dry on any agreement as yet, we cannot publish financial data on the deal. We can confirm this was a mutually-satisfying transaction and that all parties are very optimistic about the future of the technology involved. John hasn’t booked his holiday yet, but he is looking at monster caravans to make holidays a far more important part of his working life…..