IP trading ideas

THE FUTURE OF IP IN ASIA PACIFIC

SESSION 9

IP VALUATIONS

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Fundamental valuation principle

- All value is the present value of future cash flows

Data derived from listed equity markets

- Deep and liquid active market (ASX $2bn - $4bn daily)
- Instantaneously contemporaneous information
- Consensus earnings multiples (PER)
- Minority interest trades
- Observable premiums for control

Data derived from listed equity markets cont…

- Lots of readily available information in the public arena
- This information is already reflected in the readily observable market price
- High profile, large sophisticated investors have already assessed the investment in depth and priced the shares accordingly (larger Co)
- Smaller Co not usually covered in depth (still better than Pte Co)

Data derived from listed equity markets cont…

- Investment managers are powerful and can access lots of information (at least on major Co)
- There is a relatively deep and active traded market readily available

Data derived from listed equity markets cont…

- Transaction costs are low and relative to value are immaterial / trivial
- There are substantial governance pressures to ensure disclosure and arm's length dealing (or at least disclosure)

Valuation of IP

Background differs to slides 2 - 6

Either

- DCF unlisted shares
- But higher discount rates apply

Or

- Surrogate methods
- Capitalised earnings (growth in PER)
- Relief from royalty
- Residual method

Comparison of valuation methods

Investment	**Method**
• Debt instrument	• DCF
• Listed unit trust	• DCF
• Real estate	• DCF*
• IP	• DCF (or PER x EPS)
	• Why not the same way?

*** If done properly**

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Growth is in PER

- Unmet demand
- Demand growth
- Industry growth
- Entity growth
- IP has (much) greater growth prospects

DCF issues

- Free cash flow
- Terminal value
- Discount rate

= NPV

Calculating discount rates

- Cost of debt
- Cost of equity
- Cost of capital
- Start up vs steady state
- Multi stage discount rates
- Cash flow to debt and equity
- Cash flow to equity

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Beta – a measure of risk

- Beta measures risk relative to market
- Assumption is a well diversified portfolio
- Beta usually (much) higher for IP

IP

- Unsystematic risk associated with IP
- No specific model for quantification
- Matter of experience and judgement
- Errors in estimation will impact valuation

IP risk factors

- Technical risk
- Regulatory risk
- Commercialisation risk
- Investor/business manager risk
- Business risk
- Operational risk
- Financial risk
- Market risk
- Economic risk
- Industry risk
- Profitability
- Revenue growth
- Management corporate
- Governance
- Competition
- Customer concentration
- Diversification
- Employee relations

Other issues

- Small company risk premium
- Illiquidity discounts
- Dilution effect

Why you don't use rules of thumb

- Remember the Acronym
- Because their ROT
- Runs ATO risk
- Can incur lots of cost and tax penalties later on
- Simplistic valuation approach unlikely to be accepted by ATO, Regulators, Court, etc
- Makes it more difficult for buyers to arrange finance

Other issues

- Milestone payments
- Cash burn
- Very long gestation periods
- Upfront royalties
- Running royalties

Top down methodology

- Inaccurate components
- All errors compound into residual / IP

Relief from royalty

- Royalty rates
- Royalty cover (like interest cover)
- Symbiotic relationship
- Aften interest (despite some contrary literature)

Some conclusions

- IP valuations are unique
- Large valuation errors are common
- Conceptual errors magnify information uncertainty problems