
Using Royalty Rates as Valuation Benchmarks

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The "relief from royalty" technique has been used for many years in the valuation of intangible assets and intellectual property. It is based on the assumption that the owner of intangible property is "relieved" from paying a royalty to obtain its use. The technique is a permutation of the income approach in which a royalty rate (multiplied by the forecasted royalty base) is used to calculate an income stream attributable to the subject asset. Thus, the income stream calculated using the royalty becomes a surrogate for the economic benefit attributable to the intangible. A capitalization of that income stream becomes an indication of value.

We have long cautioned users of this technique that the "relief from royalty" income stream may represent only a portion of the economic benefit attributable to the asset being appraised. That is, one must be attentive to the license terms which give rise to a royalty rate taken from the "market". If those license terms transfer only a portion of the full rights of ownership (the licensor retaining the right to exploit the intellectual property for itself), then the payment for those limited rights (royalty) may not be an adequate surrogate for the full economic benefits of ownership.

In an example from the world of real estate, it is unlikely that a capitalization of the rental income from one tenant in an apartment building would be an appropriate indication of value for the entire building. To be sure, the rental income from a single tenant might be a very good indication of "market rental rates", but it might not be adequate for valuation purposes if the objective is to appraise the entire building.

This concept recently received judicial notice in a decision of the U.S. 2nd Circuit Court of Appeals in the matter of a U.S. Tax Court decision relating to Nestle Holdings, Inc. Experts for both the taxpayer and the IRS utilized the relief from royalty method in the valuation of trademarks. The 2nd Circuit, however, was not persuaded that the resulting values were appropriate, commenting:

In our view, the relief-from-royalty method necessarily undervalues trademarks...Royalty models are generally employed to estimate an infringer's profit from its misuse of a patent or trademark...However, use of a royalty model in the case of a sale is not appropriate because it is the fair market value of a trademark, not the cost of its use, that is at issue. A relief-from-royalty model fails to capture the value of all of the rights of ownership, such as the power to determine when and where a mark may be used, or moving a mark into or out of product lines. It does not even capture the economic benefit in excess of royalty payments that a licensee generally derives from using a mark. Ownership of a mark is more valuable than a license because ownership carries with it the power and incentive both to put the mark to its most valued use and to increase its value. A licensee cannot put the mark to uses beyond the temporal or other limitations of a license and has no reason to take steps to increase the value of a mark where the increased value will be realized by the owner. The Commissioner's view, therefore, fundamentally misunderstands the nature of trademarks and the reasons why the law provides for exclusive rights of ownership in a mark. Given the shortcomings of the relief-from-royalty methodology, the Tax Court erred when it adopted the Commissioner's trademark valuations. The Tax Court is instructed to examine alternate methods of determining the fair market value of the trademarks in question.

Royalty rate information can be very useful to the financial analyst and the appraiser. As with any data from "the marketplace" or about "comparable transactions", one must be sensitive to the terms of the transaction, and to the nature of the property rights involved. With this, one is prepared to judge whether such information is an appropriate benchmark for the valuation task at hand.