

Valuing intellectual property

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The valuation of a pharmaceutical patent or of a development project is one of the most demanding tasks in corporate finance. Several methods are used, often in combination. The cost approach looks at the expenditure required to recreate the asset, but it says little about its future earning power. The market approach refers to the prices paid in comparable transactions, which are difficult to find because every molecule is different. The income approach, which dominates in practice, estimates the future cash flows that the asset will generate and discounts them to their present value.¹

For projects in development the income approach is adjusted for risk. Under the risk-adjusted net present value method, each future cash flow is multiplied by the probability that the project will reach the corresponding stage, using statistics on clinical success rates. The result is discounted at a rate that reflects the remaining market and financial risk. Real options models are sometimes used in addition, because a pharmaceutical company can abandon a project after an unfavourable result and thereby limit its losses. The relief-from-royalty method, which values a right by the royalties that the owner saves by not having to license it from a third party, is common for tax and accounting purposes.

These valuations have legal consequences. They determine the purchase price allocation after an acquisition and the impairment tests that groups must perform under International Financial Reporting Standards. They also matter for tax: in a transfer of intellectual property between group companies, the tax authorities of several states will scrutinise the price. The OECD rules on hard-to-value intangibles allow tax authorities to adjust prices after the event if actual results differ significantly from the projections used at the time of the transfer.² In a biotech financing round, finally, the valuation of the company depends almost entirely on the valuation of its patents and data, since it usually has no revenues.

1 Notes

1. On the cost, market and income approaches to the valuation of intangible assets, see International Valuation Standards (IVS 210 Intangible Assets) and the corporate finance literature on biotech valuation. To be verified. ↩
2. OECD Transfer Pricing Guidelines, chapter VI, section D.4 on hard-to-value intangibles and the use of ex post outcomes as presumptive evidence. To be verified. ↩

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