HOW INTELLECTUAL ASSETS IMPACT EXIT VALUE

JUERGEN GRANER

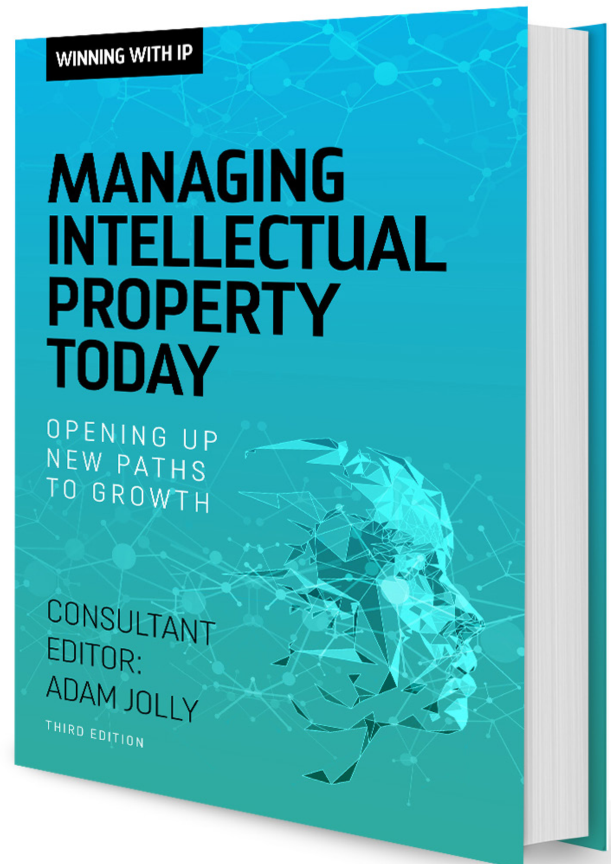
In a book about IP and the next wave of growth, the value that a business achieves at exit is heavily influenced by three intellectual assets, says Juergen Graner at Globalator: its technology, its brand and its operational excellence

Owners of high-growth technology businesses should decide at an early stage whether they are developing their company for continuation as an independent organization (build to grow) or for an exit (build to sell). They are two fundamentally different strategies open to the business leader when building a company.

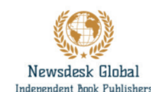
The ultimate goal when employing a build-to-grow strategy is to continue the business in perpetuity. On the other hand, a build-to-sell strategy has the clear goal of selling the business at a certain point in the future.

Key strategic decisions are made with this goal in mind and differ if the time horizon is one to three years, three to five years, or five to ten years. Anything significantly below a twelve-month time horizon tends to be a patch-to-sell approach with limited options for creating value.

A build-to-grow strategy is generally associated with a family or lifestyle business. It also applies to IPOs (initial public offerings). A build-to-sell strategy is often driven by risk reduction needs and cash-out desires of the business owners. Moreover, investor needs are an important factor to build a business with a clear exit horizon in mind. In high-growth technology businesses, the capital requirements are often so significant that bootstrapping (building a company without external equity financing) is not an option. Moreover, since debt funding is limited by the collateral that a business owner can put up, most high-growth businesses require equity funding. The majority of equity financing comes from funds with a limited lifetime (usually ten years). Therefore, they need to cash in on their investment to realize a positive return on investment at some point. This means



NOVARO PUBLISHING



Drawing on the knowledge and experience of 24 top-level IP performers, including the academy of the European Patent Office, this book discusses how IP is opening up new paths to growth, highlighting the impact of transformative technologies, such as artificial intelligence, the metaverse, Industry 4.0, net zero and personalized medicine. It gives a series of lessons and insights into how today's winners are managing their IP to create a powerful and flexible system for breaking into new markets, trading at a premium and building up future value.

Further details: www.novaropublishing.com/managing-intellectual-property-today/

that equity funding generally comes with the requirement for a build-to-sell strategy and a time frame dictated by the remaining life of the fund providing the money.

The three intellectual assets (IAs), technology, brand, and operational excellence, are generally dominant value drivers for an exit deal. Developing a sound portfolio of IAs over many years before the exit will not only provide the business owners with an increased exit valuation, it will also give the company a sustainable competitive advantage in the event a planned exit does not take place or is delayed.

Since IAs cannot be established at short notice, the process of building a sound IA portfolio must begin many years beforehand. Ideally, a dedicated board function will have prime responsibility for the sellability of the business, allowing the chief executive to remain focused on managing day-to-day operations with a steady eye on the customers. Continuous management of the exit process years in advance and for some time after the exit transaction is crucial to the best possible outcome.

Three pricing elements

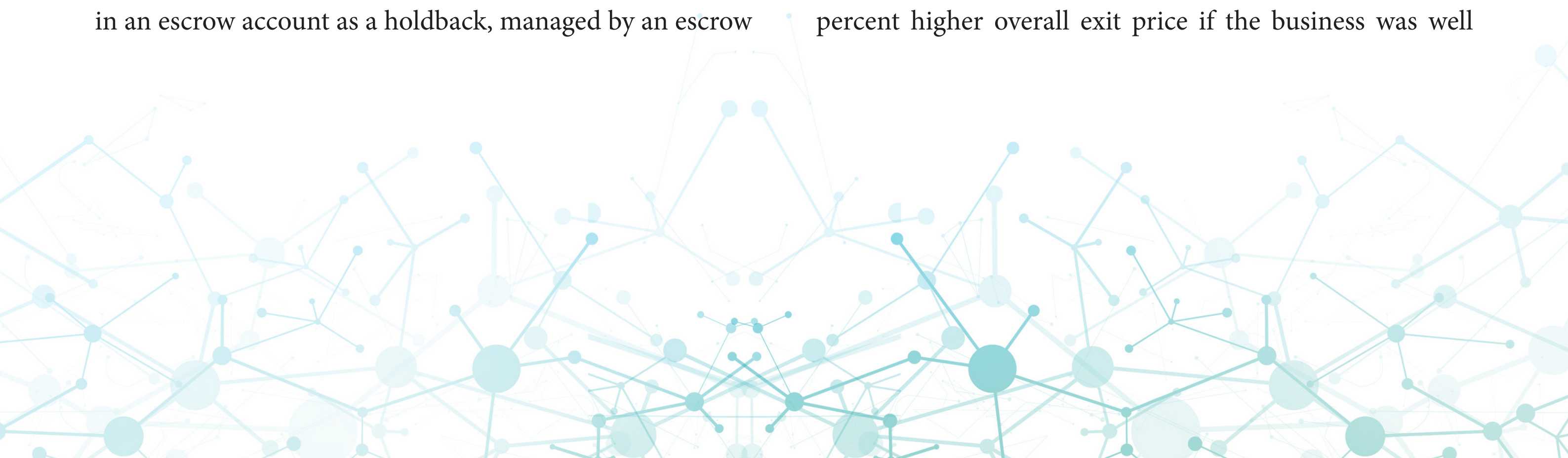
The purchase price, the first element, is the overall price that the buyer is willing to pay to acquire a business. In the case of an equity deal, the buyer receives full ownership in the seller's company (provided they buy a hundred percent of the business, although in some cases the buyer might only acquire a certain percentage). In the event of an asset deal, the buyer purchases only specific assets of the business.

As a rule, however, the purchase price is not the amount that the seller will receive once the deal is closed. In most cases, the buyer will require the seller to provide binding promises (contractually fixed under representations, warranties and indemnifications) that certain assumptions about the business are correct. One simple example is that the inventory actually represents the value claimed by the seller. To secure these promises, the buyer will ask that a certain portion of the purchase price (depending on the industry and the risks perceived by the buyer) be deposited in an escrow account as a holdback, managed by an escrow agent. This escrow holdback, the second pricing element, is subsequently released either to the seller or to the buyer, based on contractually defined terms and timelines. The initial price paid is thus the adjusted purchase price, calculated as the agreed purchase price minus the escrow holdback, ownership of which is only determined throughout the escrow period.

Companies that have been set up for high performance under new ownership through a solid build-to-sell process and supported by a strong IA portfolio have the potential to benefit from an additional earn-out, the third pricing element. An earn-out provides supplementary payments over and above the agreed purchase price for achieving defined performance criteria. In most cases, these performance criteria are based on sales performance. However, along with countless other options, they could also include certain milestones in a product development process.

While the escrow holdback has the potential to reduce the agreed purchase price, the earn-out can add to it. The tricky part about receiving earn-outs is that, by this point, control over the performance has shifted to the new owner and any success depends not only on the right preparation on the part of the seller but also on the co-operation of the buyer. While certain requirements may be put in place by the seller to enable earn-out performance, the main driver here is business logic combined with management support from the seller's team.

The following example from the life science industry illustrates the possible impact of escrow holdback and earn-out on the actual amount received by the seller (parameters depend on individual situations and industries). With a purchase price of $50 million, plus a 20 percent escrow holdback and a $20 million earn-out, the difference between a worst-case scenario (all the escrow holdback is kept by the buyer and no earn-out is paid = $40 million exit deal value) and a best-case scenario (the entire escrow holdback is released to the seller and the full earn-out is achieved = $70 million) would be $30 million. This translates to a 75 percent higher overall exit price if the business was well



prepared in a build-to-sell process and the implementation phase went according to plan. IAs are major contributors and increase the likelihood of a higher purchase price in the first place and a higher overall exit deal.

General assets

General assets typically include customers (expressed in revenue), cost structure (expressed in gross margin and profitability), established contracts, equipment, inventory, work in progress and team members. As the foundation of any business valuation, they have a substantial impact on the purchase price because they are relatively easy for the acquirer to evaluate in a due diligence process.

Since an escrow agreement needs clear trigger points to determine whether the seller or the buyer receives the retained funds, general assets also have a huge impact on the escrow holdback.

While general assets may serve as the foundation of an earn-out (eg, equipment with significant spare capacity enables the sales team to sell more products), their impact on it is usually low.

Technology assets

Strong technology IAs combine the technology intellectual property, mainly secured by patents and trade secrets, with the know-how of the team. For a company with a strong technology portfolio, the impact of technology on the purchase price can be significant, especially when it gives the business a sustainable competitive advantage. For example, patent-protected technology with a clear enforcement and freedom-to-operate position that allows the company to exclude competitors for a relevant period of time increases value as the current performance and growth pattern is more likely to continue.

The impact of technology on the escrow holdback tends to be low, as it is relatively difficult to find trigger points that would provide an escrow release payment to one of the parties. One example in which technology might have an impact on the escrow holdback is a pending patent lawsuit that could threaten a business's technology foundation where winning or losing patent litigation could determine the payout of an earmarked holdback.

From an earn-out perspective, technology can have a high impact on an agreed earn-out. This is especially true if, for example, the company owns platform technology that has only been tried and tested in one market segment but could be used to access one or several other markets. It could be part of an earn-out payment based on future sales in those new markets, provided the buyer agrees to enter those markets shortly after the deal is completed.

Brand assets

Strong brand IAs combine the brand's IP secured by trade marks with the ownership of customer mindshare, where individuals associate the brand with certain attributes.

A strong brand almost always has a powerful impact on the purchase price although the value is generally higher in business-to-consumer than in business-to-business focused companies. This is interesting as, in most cases, the seller's brand will be replaced with the buyer's brand. However, having a strong brand, where the task is not finding new customers who have positive associations with it, but transferring existing positive associations to a new brand in a controlled step-by-step process, is still of great value to a buyer.

Since a brand is generally easy to assess in a due diligence process, the impact of the brand on the escrow holdback is almost always low. One situation in which an escrow holdback might be impacted by the brand is when the acquired company does not own a registered trade mark with an uncontested status and there is reason to believe that the brand might actually violate existing trade mark rights of another company.

Earn-outs are usually based on future sales performance. Since great sales performance builds on a strong brand that

has been established over many years, the impact of the brand on an earn-out is generally high. Moreover, the value increases if the buyer can use the seller's brand to expand the product portfolio quickly by targeting the seller's existing customers with its own products.

Operational excellence

Strong operational excellence IAs allow a company to consistently outperform others and combine the operational excellence IP secured by the operational systems with a culture that enables operational excellence.

Interestingly enough, operational excellence rarely has a direct impact on the purchase price from a valuation perspective. The reason is that it is difficult to prove the actual level of operational excellence in a company in a common due diligence process. Nevertheless, since operational excellence serves a company in a build-to-sell process during the development phase towards a sellable business and can ensure high sales growth, a high gross margin and fast product time-to-market, it has a significant intrinsic value affecting the purchase price.

Generally operational excellence does not have a major impact on the escrow holdback. Although some buyers might try to link the potential loss of key employees to an escrow trigger point, the truth is that this issue is better served with a special tie-in contract, retaining key employees for a certain period of time with defined bonus payments. Moreover, it would be very difficult to define escrow payment release trigger points for underperformance in terms of operational excellence.

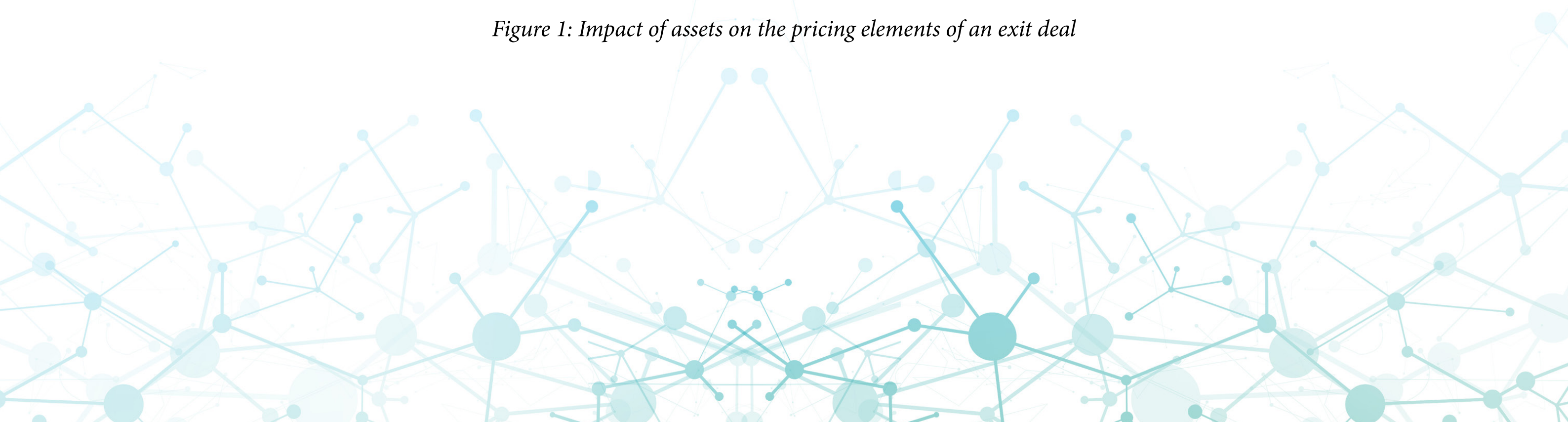
Operational excellence really shines when it comes to the earn-out. A business developed for a sale through a solid build-to-sell process will have established at least a certain level of operational excellence that makes it easier to be integrated into the company structure of the buyer. Consequently, when the former chief executive steps down and a new one takes over, a business with operational excellence will continue to perform: this performance secures the earn-out payments. However, it is important that the seller still has someone in place to manage the transition carefully and ensure a smooth handover. This role is ideally performed by a person or a team that has been managing the build-to-sell process since the development phase and is therefore familiar with the company.

Conclusion

IAs are a significant contributor to an exit deal's value and need to be established over many years during the development phase of a business.

		Purchase price	**Escrow holdback**	**Earn-out**
General assets		High	High	Low
Intellectual assets	**Technology**	High	Low	High
	Brand	High	Low	High
	Operational excellence	Low	Low	High

Figure 1: Impact of assets on the pricing elements of an exit deal



The secret to the success of an optimized exit is understanding that different assets have a different impact on the three pricing elements of an exit deal: purchase price, escrow holdback, and earn-out (see Figure 1). General assets have the highest impact on the adjusted purchase price (the purchase price minus the escrow holdback deposited in an escrow account) and little impact on an earn-out. Technology and brand IAs generally have a high impact on the purchase price and limited impact on the escrow holdback but are the key drivers for an earn-out.

Operational excellence is an inconsequential outlier in the IA class as its impact on the purchase price is more intrinsic. On the other hand, it is usually the most important driver for earn-outs.

Therefore, an owner of a high-growth technology business should ensure that a proactive build-to-sell process is initiated at an early stage, developing a solid portfolio of IAs to secure the value of the business. In the event an exit does not materialize for any reason, these IAs will continue to be the backbone of the sustainable competitive advantage that the company has built. In any case, a business cannot go wrong with a strong IA portfolio.

Furthermore, if a business owner opts for a build-to-sell strategy, they should establish a build-to-sell function at board level in their company that is tasked with guiding the company from the development phase through the transaction phase and into the implementation phase. The business owner should focus on managing day-to-day operations with a steady eye on the customers, while the build-to-sell function's prime focus is the company's sellability.

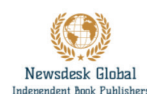
• The full version of this article first appeared in the June 2022 edition of les Nouvelles, the journal of the Licensing Executives Society under the title 'Build to sell powered by intellectual assets: a high-growth technology business perspective' and is available at: https://www.epo.org/learning/materials/sme/high-growth-technology-businesses/decision-makers.html.

Juergen Graner is founder and chief executive of Globalator in the United States, United Kingdom and Austria. He has experience as a chief executive in six countries on three continents and, over the course of his career, has coached over a hundred chief executives in creating value with strategic transactions. Juergen also regularly speaks at conferences and teaches on the subject of Transaction Based Growth Management™. He is a member of the HTB Task Force at EPO and the HGE Task Force at LESI.

Winning with IP: managing intellectual property today

Published November 2022, 182 pages, paperback,
229mm x 152mm, ISBN: 978-1-7398640-2-6

NOVARO PUBLISHING



Further details: www.novaropublishing.com/managing-intellectual-property-today/