SESSION 21: THE OPTION TO DELAY VALUING PATENTS AND NATURAL RESOURCE RESERVES

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The Option to Delay

- When a firm has exclusive rights to a project or product for a specific period, it can delay taking this project or product until a later date.

- A traditional investment analysis just answers the question of whether the project is a “good” one if taken today.

- Thus, the fact that a project does not pass muster today (because its NPV is negative, or its IRR is less than its hurdle rate) does not mean that the rights to this project are not valuable.
Valuing the Option to Delay a Project

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Example 1: Valuing product patents as options

- A product patent provides the firm with the right to develop the product and market it.
- It will do so only if the present value of the expected cash flows from the product sales exceed the cost of development.
- If this does not occur, the firm can shelve the patent and not incur any further costs.
- If $I$ is the present value of the costs of developing the product, and $V$ is the present value of the expected cashflows from development, the payoffs from owning a product patent can be written as:

$$\text{Payoff from owning a product patent} = \begin{cases} V - I & \text{if } V > I \\ 0 & \text{if } V \leq I \end{cases}$$

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Payoff on Product Option

Cost of product introduction

Present Value of cashflows on product

Net Payoff to introduction

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# Obtaining Inputs for Patent Valuation

<table>
<thead>
<tr>
<th>Input</th>
<th>Estimation Process</th>
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</table>
| 1. Value of the Underlying Asset  | • Present Value of Cash Inflows from taking project now  
                                 | • This will be noisy, but that adds value.                                                                                                         |
| 2. Variance in value of underlying asset | • Variance in cash flows of similar assets or firms  
                                 | • Variance in present value from capital budgeting simulation.                                                                                   |
| 3. Exercise Price on Option        | • Option is exercised when investment is made.  
                                 | • Cost of making investment on the project ; assumed to be constant in present value dollars.                                                    |
| 4. Expiration of the Option        | • Life of the patent                                                                                                                                    |
| 5. Dividend Yield                  | • Cost of delay  
                                 | • Each year of delay translates into one less year of value-creating cashflows  
                                 |       
                                 | Annual cost of delay = \( \frac{1}{n} \)                                                                                                             |
Biogen, a bio-technology firm, has a patent on Avonex, a drug to treat multiple sclerosis, for the next 17 years, and it plans to produce and sell the drug by itself. The key inputs on the drug are as follows:

PV of Cash Flows from Introducing the Drug Now = $3.422 billion
PV of Cost of Developing Drug for Commercial Use = $2.875 billion
Patent Life = t = 17 years
Riskless Rate = r = 6.7% (17-year T.Bond rate)
Variance in Expected Present Values = \( \sigma^2 = 0.224 \) (Industry average firm variance for bio-tech firms)
Expected Cost of Delay = y = 1/17 = 5.89%

\[
d_1 = 1.1362 \quad N(d_1) = 0.8720
\]
\[
d_2 = -0.8512 \quad N(d_2) = 0.2076
\]

Call Value = $907 million

\[
3,422 \exp^{-0.0589(17)} (0.8720) - 2,875 \exp^{-0.067(17)} (0.2076) = $907 \text{ million}
\]
Example 2: Valuing Natural Resource Options

- In a natural resource investment, the underlying asset is the resource and the value of the asset is based upon two variables - the quantity of the resource that is available in the investment and the price of the resource.

- In most such investments, there is a cost associated with developing the resource, and the difference between the value of the asset extracted and the cost of the development is the profit to the owner of the resource.

- Defining the cost of development as $X$, and the estimated value of the resource as $V$, the potential payoffs on a natural resource option can be written as follows:

  Payoff on natural resource investment $= V - X$ if $V > X$

  $= 0$ if $V \leq X$

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Payoff Diagram on Natural Resource Firms

Cost of Developing Reserve

Value of estimated reserve of natural resource

Net Payoff on Extraction
## Estimating Inputs for Natural Resource Options

<table>
<thead>
<tr>
<th>Input</th>
<th>Estimation Process</th>
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<tbody>
<tr>
<td>1. Value of Available Reserves of the Resource</td>
<td>• Expert estimates (Geologists for oil..); The present value of the after-tax cash flows from the resource are then estimated.</td>
</tr>
<tr>
<td>2. Cost of Developing Reserve (Strike Price)</td>
<td>• Past costs and the specifics of the investment</td>
</tr>
<tr>
<td>3. Time to Expiration</td>
<td>• Relinquishment Period: if asset has to be relinquished at a point in time.</td>
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<td></td>
<td>• Time to exhaust inventory - based upon inventory and capacity output.</td>
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<tr>
<td>4. Variance in value of underlying asset</td>
<td>• based upon variability of the price of the resources and variability of available reserves.</td>
</tr>
<tr>
<td>5. Net Production Revenue (Dividend Yield)</td>
<td>• Net production revenue every year as percent of market value.</td>
</tr>
<tr>
<td>6. Development Lag</td>
<td>• Calculate present value of reserve based upon the lag.</td>
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Valuing an Oil Reserve

- Consider an offshore oil property with an estimated oil reserve of 50 million barrels of oil, where the present value of the development cost is $12 per barrel and the development lag is two years.

- The firm has the rights to exploit this reserve for the next twenty years and the marginal value per barrel of oil is $12 per barrel currently (Price per barrel - marginal cost per barrel).

- Once developed, the net production revenue each year will be 5% of the value of the reserves.

- The riskless rate is 8% and the variance in ln(oil prices) is 0.03.
Inputs to Option Pricing Model

- Current Value of the asset = $S = \text{Value of the developed reserve discounted back the length of the development lag at the dividend yield} = 12 \times 50 / (1.05)^2 = $544.22$
  
  (If development is started today, the oil will not be available for sale until two years from now. The estimated opportunity cost of this delay is the lost production revenue over the delay period. Hence, the discounting of the reserve back at the dividend yield)

- Exercise Price = \text{Present Value of development cost} = 12 \times 50 = $600 million

- Time to expiration on the option = 20 years

- Variance in the value of the underlying asset = 0.03

- Riskless rate = 8%

- Dividend Yield = Net production revenue / Value of reserve = 5%
Valuing the Option

- Based upon these inputs, the Black-Scholes model provides the following value for the call:
  
  \[ d_1 = 1.0359 \quad N(d_1) = 0.8498 \]
  
  \[ d_2 = 0.2613 \quad N(d_2) = 0.6030 \]
  
  \[
  \text{Call Value} = 544.22 \exp(-0.05)(20) (0.8498) - 600 (\exp(-0.08)(20) (0.6030) = \$ 97.08 \text{ million}
  \]

- This oil reserve, though not viable at current prices, still is a valuable property because of its potential to create value if oil prices go up.