What VC and PE practitioners need to know about IP

When considering intellectual property as an asset class, investors must approach due diligence and post-deal management a little differently to reap the benefits

By **Chris Donegan**, Fraserburgh

There are about 240 venture capital (VC) funds active today which finance around 1,500 new companies each year. Approximately 20% of these companies generate 80% of VC fund returns.

VC funds are a subset of the much larger private equity (PE) universe, in which more than 75% of the 3,500-plus funds focus on buy-out, growth capital or later-stage investments in relatively small size. Of the 11,000 deals concluded annually, most are valued at less than $100 million, which will not make the front page of the *Wall Street Journal*.

Advocates of VC/PE believe that since private companies are not obliged to meet quarterly analysts' earnings targets, they will be managed more strategically, enabling them to focus on innovations that generate long-term equity value. While multiple studies have confirmed that, on average, VC/PE-backed companies outperform their non-VC/PE-backed peers, these studies do not reveal the expected correlation in terms of innovation, based on number of patents filed or cited.

Intellectual property is rarely the primary driver for a VC/PE transaction. Common factors that determine 'go' or 'no-go' for investors include:

- management track record;
- valuation;
- complexity/technology risk;
- downside protection;
- market size;
- funding costs;
- competitive landscape;
- industry comparators; and
- obvious exit routes.

In this context, it is perhaps unsurprising that VC/PE-backed companies such as Google, Facebook and Groupon were built without a bedrock of valuable patents, although Google has subsequently backfilled its portfolio with its $12.5 billion acquisition of Motorola Mobility's intellectual property.

However, this situation may be changing. The VC/PE industries are cyclical and in 2013 the investment horizon is unfavourable for classic VC/PE strategies that require large amounts of debt. Banks are not funding leveraged buy-outs and it is politically difficult to generate operational cost savings through lay-offs during a recession. VC/PE firms are thus refocusing on improving the fundamentals of the companies that they buy by driving sales, protecting margins and exploiting intellectual property. Furthermore, some key industry sectors that are attracting capital are IP rich. These include smartphones, software, music publishing, film, biotech and medical devices. It is in this respect that a better understanding of intellectual property and a coherent IP management strategy can bring significant value.

Given this context, and after seven years working with VC/PE investors in IP-related transactions, I would like to dispel some myths and provide food for thought for VC/PE investors considering intellectual property as a business asset.

Intellectual property confers legitimacy, which has economic value

Rights holders have legitimacy. Legitimacy is a soft benefit most of the time, but is important to companies which care about projecting a certain image to their investors (often major institutions) and analysts. Intellectual property provides an underpinning fact base that supports a brand proposition. Innovative companies patent and protect their inventions. Brand quality and product quality are synonymous in the eyes of customers. The halo effect is powerful if strategically managed and marketed. Owning IP rights positions a company and its investors on high ground competitively, legally and from a brand perspective. The net effect is better and clearer product or service differentiation, favourable perceptual positioning and the ability to charge a premium for the product or service offering.

IP value can be determined within a VC/PE investor framework

VC/PE investors often have difficulty proving *a priori* the monetary value of intellectual property. There are many reasons for this, including litigation history, cash flow and availability of comparative benchmarks. For example, royalty-generating copyrights are intuitively easier to value than patents that may confer strategic advantage, but produce no direct income. The methodology used to value intellectual property may be unfamiliar to the investor, or may fail to provide the level of objective certainty that is the industry norm for buyers of tangible assets.

All valuation methodologies commonly used for intellectual property use discounted cash-flow analysis of actual or assumed royalty streams, where the discount takes into consideration the duration of the effective life of the product. However, discounted cash flow is helpful only where royalty data is available. More often than not, some approximation of value is necessary. This may be based on:

- market valuation – namely, the actual price offered for the intellectual property in the secondary market;
- evidence of use, where an imputed value is given to a patent based on its contribution to the sales revenues of products that incorporate it; or
- market comparability, where the intellectual property is benchmarked against a large number of public transactions to generate an average value per patent.

Aside from the difficulty in conclusively proving the value of an intangible asset, whose value may be significantly different depending on the rights holder, there are also VC/PE-specific factors. One of the most common relates to the desire for funds to demonstrate valuation uplifts within relatively short timeframes following investment.

The VC/PE investment paradigm is based around investors' ability to demonstrate added value to the business that they are buying. Historically, a large part of this has derived from the discount to fair value at which the assets are acquired. However, calculating fair value for intellectual property can be tricky. For patent portfolios, one approach is to sell some patents to provide an average price per patent and thus rebase the entire portfolio. This can be misleading, since patent portfolios behave like options with skewed value distribution and the benchmark price is therefore unlikely to be representative. Monte Carlo analysis may be used on large portfolios to provide a more objective valuation, but this can lead to false precision, since qualitative analysis drives the input variables. The default position is often to value according to the cash generated by the portfolio over its life, which results in volatile valuations, as portfolios pass revenue milestones.

Licensing revenues are pure earnings

The value to investors of a properly structured licensing and litigation strategy to defend and support intellectual property cannot be overstated. However, few companies excel in this area. Historically, companies such as Lucent, IBM, Nokia and Qualcomm have generated hundred of millions of dollars from such activities as part of their day-to-day operations. More recently, specialist IP companies such as Round Rock Research have demonstrated the value of this as a pure-play business model.

In the creative industries, a properly structured IP protection (litigation) strategy is indispensable, and a well-established industry architecture exists to support this. For example, the network of collection societies in the music business enables copyright holders to register and audit their rights on a cost-effective basis. Litigation – or the threat thereof – is essential for this process to work.

There are a variety of approaches through which to get a licensing or enforcement programme underway, including using an IP professional or outsource partner, whereby the costs of the programme can be mitigated through contingency-based work. Some investors may be uncomfortable with this strategy, as they often have other portfolio companies that may be litigation targets for an independent enforcer. Notwithstanding this complication, earnings from licensing directly hit the bottom line and the boost to earnings before interest, taxes, depreciation and amortisation and internal rate of return (IRR) is immediate and significant.

The easiest way to gather market share is to have a monopoly

Rarely does a VC/PE investor buy a company without competitors. The strength of a properly constituted and managed IP portfolio is that it provides the investor with exactly this – the right to exclude others. In this respect, intellectual property may be used as both sword and shield. This is increasingly important in highly competitive and cannibalistic technology markets (eg, smartphones). For a company in the technology sector, where market share is critical, establishing a dominant brand position and barriers to entry for competitive products is a primary driver of success. The best way to gain and retain market share is to exclude a competitor from the market entirely. Only ownership of intellectual property provides this option.

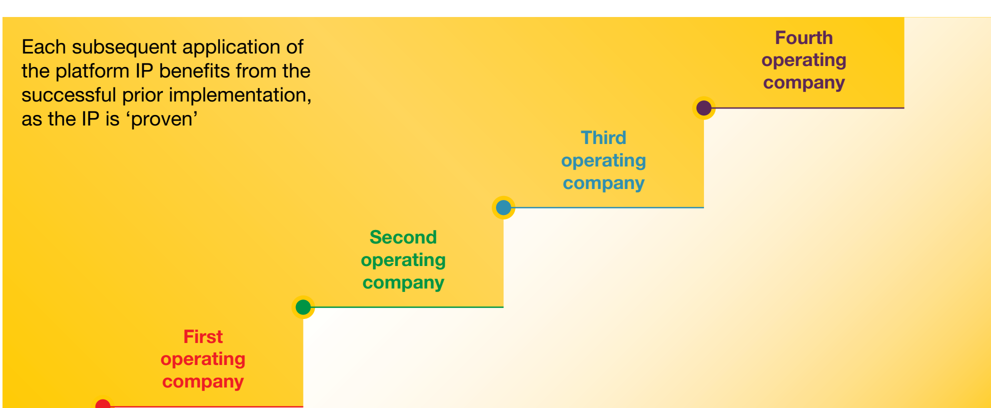
In certain situations, intellectual property is essential for the product or service being offer and the uniqueness of the intellectual property gives the rights holder unparalleled negotiating power. This can create either a premium-priced product or a utility-type business model. For example, when making a biopic about a famous musician, the right to play his or her music is fundamental to the project and therefore the primary price driver. In contrast, Qualcomm develops and licenses fundamental wireless technologies to all mobile communications companies, billing them much as a utility company would charge for water.

Intellectual property provides optionality and different paths to value realisation

There is ample evidence that no matter how great your business model is, market reality almost always requires changes. These may be minor or substantial. In this respect, intellectual property often provides the substance that allows this flexibility.

Intellectual property can turn competitors into customers with no net margin

The 'staircase effect' of platform intellectual property



> "Buyers which can work in harmony with sellers to carve out a win-win result will find themselves with a competitive edge – willing sellers at their disposal in a supply-constrained auction market"

reduction. This is a well-trodden path in the pharmaceutical and medical device sectors, where the costs to market are huge for regulatory and competitive reasons. Once a small VC-backed company has proven its technology, the most common route to market is not an initial public offering, but an exclusive licensing transaction with a major firm. This leverages the economies of scale in sales and marketing that big pharma possesses and provides investors with risk reduction in execution.

Similar cooperative strategies are emerging in the cloud computing arena, where expert providers of secure communications are providing incumbents with a wholesale utility product, rather than competing head to head for end client contracts.

Platform intellectual property is more valuable than product intellectual property

Platform intellectual property may be expressed through various different operating companies and thus effectively monetised multiple times. Good examples include drug-delivery systems that may apply equally to the oncology and dermatology fields, where each operating company licenses the technology for its specific sector, but leaves the investor owning the parent intellectual property to monetise in a different sector in the future.

Such IP platforms benefit from each successive monetisation, which incrementally increases the value of the platform from royalty streams and the value of each new operating company by virtue of the platform's track record. The effect is a staircase or ladder, where the second application has value at time zero simply because of platform brand.

Intellectual property may be managed across the entire portfolio to enhance fund IRR

Most PE/VC firms leave the management of the intellectual property in each portfolio company to the individual management teams of each company. This approach mirrors that of some multinational companies (eg, GE), which drive IP management into operating businesses in order to make intellectual property accountable and a profit-and-loss-relevant item. However, this approach creates diseconomies of scale. An alternative approach is to create a group IP management function (eg, Nokia) that fosters synergies and manages intellectual property strategically. For a large PE firm with say, more than 40 portfolio companies, the synergy and value from managing intellectual property in this manner could be significant on a fund IRR basis, while aligning IP strategy with the firm's objectives.

Litigation and licensing will not damage your reputation

VC/PE funds often shy away from litigation as a legitimate revenue line item. The frequently cited reason for this is that the 'reputational risks' are considered too high. This is arguably a misunderstanding of the purpose that litigation serves in the day-to-day IP world, compared to the activity of a troll or corporate activist. In this context, it is not so much what you do that has impact, as how and where you do it.

My observation is that legacy plays a role here. Some VC/PE investors have been the victims of prior bad press that precludes them from normal enforcement activity on behalf of portfolio companies.

Simply put, if you own intellectual property it is legitimate to defend and assert it. For operating companies, the greater reputational risk lies in failing to protect your intellectual property, which could lead to unfettered brand dilution and erosion of your margin protection.

Obey the Fortune 500 rule

A few years ago, a successful PE firm explained to me that the value of investments in companies that it had acquired showed no correlation to the calibre of the management team, the price that it paid for the assets, the product market, sector or geography. However, what did correlate with returns was the identity of the seller. This drove them to deal only with Fortune 500 companies.

The rationalisation of this observation is that blue-chip originators of intellectual property have superior compliance, filing and documentation procedures, leading to fewer nasty surprises post-acquisition.

If you are going to buy trademarks, copyrights, patents or brands, the rights holder that you buy them from is important. An exception to this Fortune 500 rule may be in highly creative industries where intellectual property may be owned wholly or partially by its creator. In this case, the value of the intellectual property may outweigh the potential compliance risks.

Think long term

Great intellectual property is rare. Sellers remember what it was like dealing with a particular buyer and often the sale is not the end of the relationship. In the music industry, songwriters retain an interest in how their works are exploited and may litigate if works are used inappropriately (eg, Sting/Virgin Publishing) or leave (eg, EMI/Terra Firma). In the technology sector, the seller or inventor may prove critical in an enforcement action years after the event (eg, Severinsky/Toyota). Some sale agreements impose non-compete clauses on the seller, subject to royalty payments and commitments to support a roll-out. One of the largest legal settlements in the medical device industry (Michaelson/Medtronic) resulted from failure to honour such an agreement.

Satisfied sellers become nodes of influence that drive new intellectual property towards quality buyers. Buyers which can work in harmony with sellers to carve out a win-win result will find themselves with a competitive edge – willing sellers at their disposal in a supply-constrained auction market.

Conclusion

The notion of intellectual property as an asset class that can generate value for VC/PE transactions has greater merit today than at any other time in the past decade. However, in considering intellectual property in this manner, VC/PE investors must approach due diligence and post-deal management a little differently. Those able to do this will reap the considerable benefits available from intellectual property and position themselves as preferred buyers in the minds of the creators and rights holders of this unique asset class. iam

Fraserburgh.

Fraserburgh
84 Brook Street, Mayfair
London W1K 5EH, United Kingdom
Tel +44 20 7866 6177
Fax +44 207 866 6175
Web www.fraserburgh.uk.com

Chris Donegan
Chief executive officer
chris.donegan@fraserburgh.uk.com

Chris Donegan is an *Intellectual Asset Management 300* IP strategist who specialises in working with investors to monetise intellectual property from multinational companies.

Dr Donegan is a former research scientist, investment banker and management consultant, and holds a PhD in molecular neurobiology from Imperial College London.

Dr Donegan is an International IP Strategists Association fellow and an adviser to the Advanced Studies Centre at Keble College, Oxford University.