Column
IP Investor

Written by
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Performance anxiety

When it comes to understanding what innovation rights such as patents mean to public company performance, CEOs are hiding in plain sight

A business's huge investment in innovation deeply affects its bottom line. Still, patents for most global 1000 managements are apparently too elusive to get a handle on. In fairness, there are few reliable measures of patent performance. Accounting for their complex strengths is demanding. But if executives give up trying, failure may open the door for regulators and others. The US Supreme Court is already looking into patent quality and strategy. The lack of benchmarks may also lead to shareholder suits or activist investors who wish to replace managements or join them on the board.

Ignorance about how rights perform is no excuse. This is a potentially risky and sometimes coy response to patents' complexity and purpose that discourages honest discussion about how businesses are best run. IP managers have not been much help. However, unlike CEOs, CFOs and boards of directors, they are not responsible for generating shareholder value.

Companies must realise that the failure to understand patent performance sends the wrong message to investors and others. It implies that measuring the impact of innovation is outside of their realm, impossible or unnecessary. Some believe that litigation is the only real way to identify most important inventions and that other methods are too subjective or insufficiently rigorous.

Revenue quality

Many companies report informally about their patent royalties because it is a relatively simple matter. They represent payments in exchange for the right to use an invention. Patent royalties are much higher-quality revenue than product sales and licensors are fond of reminding us of this. Marshall Phelps, now chief of IP strategy at Microsoft, told me that when he ran IBM's licensing programme in the 1990s, margins on royalties were better than 95%. That's performance by any standard.

This may be music to a CEO's ears. But what about companies that successfully deploy patents without generating royalties? How do we know what their IP is contributing to the bottom line? While for some, invention success may equate to royalty streams, for others it may reflect improved market share, profit margins or freedom to operate – and how do you value those attributes? Very carefully, is my guess.

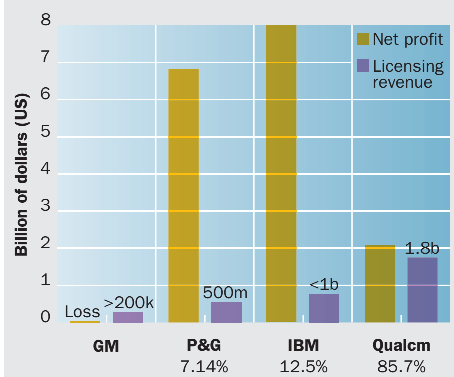
One measure

Patent licensing is only one measure of R&D performance, management skill and financial results. At ratings agencies Standard & Poor's and Moody's, cash flow or royalty streams are what really matter when it comes to modelling IP assets for securitisation. Other measures that should be applied to patent performance are not always readily apparent or relevant to credit analysis. These include patents' role in achieving or maintaining: market share (freedom of action); profit margins; product sales; customer relationships (sales); M&A; shareholder value; reputation; and capital formation.

We recently posted on the Brody Berman Associates website a graph. I call it "IP Profit in Perspective". It represents patent licensing revenue as a percentage of four large companies' net profit. The graph illustrates the importance of patent royalties to overall company profitability. The companies were selected because they represent fairly diverse patentees and industries.

Troubled General Motors has some licensing income (estimated) which contributes a small amount to its beleaguered bottom line. P&G, long associated with consumer bands (Tide®, etc), has come to rely on patent licensing to produce company-wide financial results. More than 7% of its net profit comes from patent licensing. IBM, long seen as a poster child for IP, provides 12.5% of its net-net via IP licensing (some of this is copyright and brand-related licensing). The irony is that household products giant P&G is now relying on patent licensing in much the same way as high-tech leader IBM does. When it comes to Qualcomm, which manufactures few, if any, products, company performance is mostly about patent licensing. Royalties comprise 85.7% of its net profit and about one-third of its overall income

IP profit in perspective
Patent licensing revenue as a percentage of net profit 2006



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Getting atop the bottom line

There is an extraordinary need to quantify the role of invention rights in profitability and the creation of shareholder value. The particular method I have suggested is only one. (In future IP Investor columns I hope to discuss others). Most agree that patent count is among the weakest measures. Patent citations may show relevance to an area of technology or PTO classification, but they do not convey patents' complex role in company success or stock price. For now, even a weak measure would be better than none. CEOs: come out, come out wherever you are.

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