RPX, an IPO and a question of future direction

Although defensive patent aggregator RPX Corporation has been an outstanding success since its launch in 2008, those seeking to buy shares via its proposed IPO may have questions before opting to invest their cash

The story goes that the idea for RPX Corporation was hatched in a Chicago restaurant while John Amster and Eran Zur were dining together after having attended an Ocean Tomo IP auction that had taken place in the city earlier that day. It was October 2007 and Amster, now RPX's CEO, had been in town to do some bidding on behalf of Intellectual Ventures; while Zur, RPX's chairman, was there as a representative of the Lemelson Medical, Education & Research Foundation, where he headed up the licensing operation.

If the story is right, then it took less than a year to get from the dinner table to launch. By September 2008 RPX was open for business as a defensive patent aggregation firm, having secured backing from Kleiner Perkins Caufield & Byers and Charles River Ventures. It then set about attracting clients. Among the first were IBM and Cisco, and by the end of March 2009 there were 11 companies on the roster. These included Seiko-Epson, Panasonic, Philips, LG Electronics, Samsung and TiVo.

Simple proposition

All RPX's clients were attracted by its very simple proposition: the firm uses the subscription fees it generates to buy patents that might otherwise have been used by non-practising entities (NPEs) in assertions against RPX members. For an annual sum that can be as low as US$60,000 or as high as US$6.2 million, depending on size, a member receives a licence to all patents and associated rights in the RPX portfolio, as well as those that were a part of it but have been sold on. What is more, the firm makes clear that it will never enforce the patents in its portfolio. In short, what RPX is offering is an insurance policy. It will not eliminate all NPE-related patent litigation in which its members might be involved, but if the firm does its job well, it will make it less of a threat; so that, in theory at least, clients should end up saving a lot more money than the annual membership fee they pay.

It is a concept that has very quickly won widespread favour. That pool of 11 clients in early 2009 has now swollen to number over 70. Companies with a combined market capitalisation that runs into the hundreds of billions of dollars have signed up. RPX is itself generating a great deal of cash as a result. We know this because the firm has told us. In an S1 registration form filed with the US Securities and Exchange Commission this January, RPX states: "Our revenue has grown rapidly, from $0.8 million in 2008 to $32.8 million in 2009 and $65.2 million for the nine months ended September 30, 2010, and we attained profitability in 2009, our first full fiscal year of operations. Our net income increased from a net loss of $5.2 million in 2008 to net income of $1.9 million in 2009 and $10.0 million for the nine months ended September 30, 2010." By any standard, that is quite a performance from a start-up which is less than three years old.

Level of interest

Form S1 is filed in the US as a prelude to an IPO. Sometime this year, it seems, RPX is to sell up to US$100 million worth of its shares in a move that will be underwritten by a group of institutions including Goldman Sachs and Barclays Capital. The buzz the IPO generates, and the extent to which the shares are taken up, will reveal a lot about the way in which mainstream investors view the IP marketplace. So the big question, not just for RPX's founders, senior officers and backers, but also for many other operators in the IP industry, is what level of interest will there be?

On the face of it, a business that has grown as quickly and as successfully as RPX has done should not have too much of a problem in finding people to buy its stock. But things are never as simple as that. Although RPX has been a huge success up to now, the issue is whether its current business model will allow it to continue to be as successful into the future.

RPX's S1 registration states: "Upon initial subscription, to the extent that we are contractually able, clients receive a term license for the period of their membership to, and a release from all prior damages associated with, patent assets in our portfolio. Clients also receive a limited right to purchase certain of our patent assets for defensive purposes in the event of a patent infringement suit brought against a client by a third party. In addition, clients receive term licenses to substantially all of the patent assets we acquire during the period of their membership. Our subscription agreements also include a vesting provision that converts a client's term licenses into perpetual licenses if the company remains an RPX client after the specified vesting period and thereafter, on a rolling basis."

In effect, what this means is that in order to retain clients after the vesting period, the firm needs to keep on acquiring patents. It also needs to do this so that it can attract new clients. The S1 states that from the time it began operating up until 31st December 2010, RPX had spent US$250 million on acquisitions. By contrast, it had generated revenues of slightly under US$100 million. The profits that the S1 reports seem to be achieved by the way in which the value of the patents RPX acquires is amortised. But the issue for investors is how easy the firm will find it to recoup its spending over a longer period if it has to keep on buying patents in order to secure membership renewals and bring in new blood.

Money-making choice

One option is for RPX to focus much more on selling the patents in its portfolio. Although the firm itself is precluded from enforcing them, there seems to be nothing preventing it from letting them go to other entities that could use them to underpin an aggressive monetisation strategy. Neither does there seem to be any reason why RPX could not ensure that it gets a

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share of any proceeds derived from the assertions that such purchasers might undertake. This privateer model has become increasingly popular over recent years and has been used by a number of well-known outfits, including Intellectual Ventures and Micron. But acting in this way does have a potentially significant downside for RPX, as it may have an impact on the trust levels between the firm and its clients on which the S1 places so much emphasis. What is more, the fact that so many companies already have perpetual licences to the patents that would be sold will inevitably restrict a buyer's ability to enforce and so reduce the amount it will pay for the rights, as well as the cut they might be willing to share.

The S1 also states that key employees of the firm can "terminate their employment with us at any time without penalty". For investors this may be another source of worry. The RPX business model is heavily dependent on the skills of the people the firm employs, as the service RPX provides cannot be commoditised. It is the knowledge and the contacts of the management team at the firm that enable the right patents to be identified and purchased, the client base to be developed and the strategic direction to be successfully mapped; as the S1 states: "The loss of one or more of our key employees could seriously harm our business." Investors in it for the long term will surely want to have a level of comfort that senior RPX management is too. This is especially so as the barriers for entry for any potential competitors are low: for the right people with the right connections, it is just a matter of getting the financial backing to start buying patents.

Great business

Yet despite the potential downsides in the future, what RPX has shown since 2008 is that defensive patent aggregation is a great business to be in. Operating companies in certain industries feel vulnerable to NPE actions and as a result they are willing to pay decent money to reduce their exposure to potential litigation. And this is at a time when more US patents are being issued than ever before. As things stand, not many organisations are offering the kind of services that RPX is offering, so operating companies looking to mitigate their litigation risks have few other options.

Anyone thinking about getting involved with RPX via its IPO will know how to read the firm's accounts accurately. What they may be far less certain about is how the IP marketplace is going to look in even two or three years' time, and how that will affect RPX's strategic choices. But what investors may end up deciding is that a business with a lot of powerful friends in the high-tech industry, and which owns a great deal of valuable IP, is always going to have a few options: just as long as it has the right people making the right decisions at the top. And if this is how investors do see it, Amster and Zur are going to be able to enjoy any number of dinners far more opulent than the one they shared in the Windy City four years ago. ■