Column
IP Merchant Banker

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Penny foolish and pound wise?

Investing in the creation of IP is like investing in the property market. You have to know what you are doing if you are to succeed

The fate of successful enterprises is to become a bank – *Anonymous*

St Louis, Missouri, 10th January 2007: Saving money is one of the uncontestable virtues. From birth we are taught that saving for a rainy day is a necessary reflex that protects us from life's occasional misfortunes. Savings are also the seed corn from which capital can be aggregated to finance new enterprises. Such redeployment of thrift is a bulwark of capitalism. But occasionally consumers fail to save – 2005 was such a year and 2006 is not likely to be much of an improvement.

According to Chris Isidore in a 21st December 2006 *CNN money.com* column: "The last 19 months have shown a negative savings rate. That means American consumers are spending more than they're taking home after taxes. The savings rate was a negative 0.6 percent in October. In other words, the typical American spent US$100.60 for every US$100 of take home pay."

Among the G8 nations, Americans have always ranked among the lowest of savers when measured by funds kept with financial institutions. However, one of the blessings of the American economy has been a bountiful supply of affordable housing, an asset that has historically appreciated with time. As a nation of homeowners, much of America's savings is in the form of real property. We are also a nation of mortgagors, which means most Americans are in partnership with financial institutions. But when we subtract out the interest paid on a mortgage, there is a principal payment, which is a consumer's *bona fide* investment in property. When real property appreciates, it adds to the principal. And when all of that is added back to financial savings, Americans are generally as thrifty as the rest of the developed world.

In this sense, American consumers neatly imitate the behaviour of businesses, in that business savings taking the form of investment in properties will reliably appreciate with time. For businesses engaged in goods and services, real property investment is just one kind of asset that may drive the desired enterprise appreciation.

More often, proper investment in intellectual property yields a better economic return for business. For businesses that use research and development to create intellectual property, expenditures can typically range from a quarter to nearly half of pre-tax profits. Interestingly, this is the same as the affordable range for homeowner mortgages when measured against income.

R&D is a fairly risky undertaking and the failure rate for even well-planned research projects considerably exceeds the default rate on home mortgages. Conventional wisdom always supports the reduction of risk, so businesses, especially the well-established ones, tend to perform research and development with emphasis on the big "D" rather than the little "r". This creates two general tendencies in the resulting intellectual property. First, it tends to create nominally more intellectual property, by focusing on incremental advantages to the original prior art. Second, the incremental benefits tend to be appendages, which tends to increase the complexity and cost to use the improvements while only marginally increasing the profit opportunity in comparison to that served by the prior art.

By staying close to the original prior art platform, shareholders are assured of successful intellectual property creation. However, their expectations of reward are over-extended because they expect a similar value increase to the original invention. When these expectation cannot be borne out, it can and generally does have a devaluing effect on the business.

This is not so different from the homeowner who, upon seeing the appreciation of properties around him, takes out a loan against his or her home equity to remodel a bedroom. While the homeowner may be pleased with his or her handiwork and perceive a commensurate increase in property value, a future buyer is unlikely to pay much for the improvements as they are incremental at best when compared to the buyer's aesthetic tastes. Once this irrational exuberance is revealed, home equity values can and do deteriorate. This is what happened in 2006. Both situations suggest there are questions that can be asked by homeowners and businesses to guide their investment decisions in 2007.

- Question 1: Are you investing in a property or in its fixtures? It is often easier to acquire fixtures for real estate or improvements on existing patents, but returns on investment are usually inversely proportional to the ease of acquisition.
- Question 2: Are you taking enough investment risk to justify your expectation of rewards? Revolutionary IP is about the willingness to be surprised by what is possible and doable – even if 95% of the time you discover the impossible and undoable. Or are you investing thousands in the kind of blighted neighbourhoods that sometimes become million-dollar urban co-ops (and sometimes don't).
- Question 3: Are you more concerned with conventional wisdom or personal conviction? Luck, like lightning, never hits the same spot twice. Yet how often in R&D planning do we stress core competencies as the strategy to deliver critical knowledge assets? In real estate, it's location, location, location. Following that advice in 2005 for the hot markets of Las Vegas, Miami and Los Angeles would have resulted in 8% to 10% losses in property value for 2006.

Finally, if there are no clear strategies to invest for assets, maybe going to the bank (or for businesses, becoming a bank) is not such a bad idea. Compared to life's 'sure thing' bankrolling someone else's luck might be the payday you are looking for.

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