

Another arrow in the IP quiver

Instead of leaving unused and unwanted intellectual property rights to wither on the vine, companies should think carefully about whether they are suitable candidates to provide the launchpad for a corporate spinout

By **Jim Huston**

Regular readers of *IAM* are well acquainted with the various business models around licensing IP in all its facets. But as licensing practitioners know all too well, finding the right licensor who is willing to offer a reasonable ROI is not always an easy – or even realistic – task. This is especially true for stranded pre-revenue technology projects inside of big companies: ones where millions of dollars and multiple man years have been invested but the parent has shifted strategies, or has realised that the target market is one they can't serve or that it just isn't a big enough opportunity to move their needle.

Often, attempting to monetise this dormant IP via licensing delivers less value than expected and may have hidden costs. The licensor receives surprisingly little compensation for the IP given its early-stage nature. With further development of both the technology and the business model, the licensor could bring the technology to a point where it might fetch a higher price tag, but this requires more time and money to be invested for an uncertain outcome.

Similarly, the licensee may be wary of acquiring unproven IP with uncertain market prospects that is thrown over the wall. Without access to the requisite talent (ie, the original engineers), the licensee may find it difficult to take the raw patents and turn them into commercial products. And, of course, there are the hidden costs of trying to assert IP against potential infringers – IP lawsuits are very expensive and the mere act of approaching a potential infringer can harm other business relationships with

customers, partners or suppliers, as very few companies greet a patent infringement demand letter with open arms.

Many companies, however, now see that there is an alternative mechanism for realising the value of unused or underutilised technology-based IP – the corporate intellectual property spinout. Unlike patent licensing or buy-outs, the corporate IP spinout model is based on taking equity in a newly formed company in lieu of licensing royalties or upfront cash payment. This can be a great way to make money for those investors who participate in these kinds of venture deal. You can think of spinouts as being just part of a broader continuum of monetising IP – another arrow in your quiver – as shown in Figure 1.

The VC model

Blueprint Ventures is not an IP consultancy or IP brokerage. We are a Silicon Valley-based technology venture capital (VC) firm. Our business model is to find promising technology-based ventures to invest in; after investment, we typically take a board seat, help executives grow their business and stay with them until an exit. So what brought us to corporate IP spinouts? Two words – capital efficiency.

In the post-bubble meltdown of 2001/2002, we realised that the venture business had fundamentally changed – with IPOs all but dead in the US, a good venture exit was likely to be a US\$200 million to US\$300 million acquisition. But this was only a good exit if no more than US\$25 million to US\$30 million in total capital had been invested in the company. It turns out that over the years we had done several corporate IP spinout deals and these were

some of our best-performing and most capital-efficient deals – able to generate great returns on minimal invested capital. Not exactly rocket science: projects with extensive prior development require less capital going forward. But with this insight, Blueprint Ventures has identified corporate IP spinouts as a means of achieving capital efficiency and of generating venture-style returns to our investors.

Even today, in a nearly recovered tech environment, newswires are filled with stories of start-ups that raised US\$75 million or US\$100 million in funding only to be acquired for US\$50 million. For example, the mean value of Broadcom's more than a dozen acquisitions over the last few years is right at US\$50 million. But these companies had, on average, US\$35 million of venture capital invested in them. The story is similar if you look at the acquisitions of Oracle, Intel, Microsoft and many other tech giants.

Overall in 2006, there were 404 reported acquisitions of venture-backed companies in the US (and many more liquidations or fire sales that were not reported). While the mean value was US\$77 million, this includes the US\$1.65 billion acquisition of YouTube by Google. The median value was actually much lower – around US\$45 million; which sounds pretty good, until you realise that on average each of these companies had US\$22 million of venture investment and some had much more. Considering the amounts invested in these acquired start-ups, these exits are a far cry from the 5x to 10x return venture investors expect and their limited partners demand. But where do you find those investments with 5x to 10x potential return? One way to do it is by seeking early-stage corporate IP spinouts.

Back to the future

Corporate IP spinouts aren't exactly new. Well-known companies such as Cienna, Verisign, 3Com and Adobe all started out as spinouts from corporations. But spinouts are hard deals for many VCs to do: compared to traditional start-up deals, they are typically more complicated to structure.

Often, the corporation doesn't know if it wants equity, royalty or upfront cash (answer – it's all negotiable – but don't expect to recover your sunk cost upfront). Or the corporation doesn't know exactly what it is willing to do with the IP (answer – while an assignment of the patents is preferred, it is not always essential). Or the corporation doesn't know which people it is willing to let go, or perhaps the people aren't sure if they want to leave the

Figure 1. Corporate IP spinouts – the sweet spot

Patent	Project	Product	Division	Company
No team	Engineers	All disciplines	Team w/management	Full organisation
No product	Prototype	Marketable product	Product family	Mature product line
No customers	Market feedback	Market validation	Select customers	Customer base
No revenue	No revenue	Initial revenue	Growing revenue	Predictable revenue
IP licensing (university & corporation)	Early-stage IP spinouts	Early-stage IP spinouts	Venture buy-outs	Traditional buy-outs

mother ship (answer – having the core tech team come over is essential – IP transfers through people, not paper).

For all these reasons and more, many VCs will look at spinouts only if they are already packaged up to look like traditional venture deals. But the reality is that most spinout opportunities are still quite raw and few corporations do enough spinouts or venture deals to really know how to package these deals.

IP everywhere

Hundreds of billions of dollars are invested in corporate R&D annually, generating a huge amount of IP in the process. Yet many R&D projects lose their relevance over time and most patents never result in commercial products or licensing value. The resulting technology may be perfectly useful and in fact quite valuable, but it simply may not be suitable for its current home.

This situation arises for a variety of reasons (Figure 2 and below):

- Strategic misalignment: corporations sometimes choose to shelve promising early-stage products because they are no longer core to their strategy. The high-tech landscape changes quickly, causing a company to pursue a new product or market focus and halt once-critical R&D projects. Companies exit business lines and shift strategies all the time, leaving research in those product areas stranded.
- Restructuring/rebudgeting: all corporations periodically review which projects will continue to get funded and at what level. And, of course, there is the out-of-cycle restructuring that hits many companies on occasion. Many projects which looked promising can quickly become orphans in

the wake of aggressive downsizing or budget pruning.

- Too much “R”, not enough “D”: many corporations invest a portion of their R&D budget in basic research, where researchers focus solely on innovation rather than revenue opportunities with the hope of eventually finding a fit within the company. While this approach occasionally translates into blockbuster products, most basic research projects fail to reach the commercialisation phase because they fail to find a practical application within the company’s markets of expertise.
- Wrong market: corporations may expend resources on a new project only to decide later to discontinue funding after further market analysis reveals an insufficient – or uncertain – market opportunity. Most VCs would rush to fund technology addressing a potential US\$500 million market, but it may not be large enough to move the needle at a multi-billion dollar corporation; or it is deemed too risky versus other opportunities facing the corporation; or the corporation learns that the best target market for the project is one it can’t or doesn’t want to serve.

Parent corporation: what’s in it for me?

Corporate executives will often question whether a spinout is worth the hassle as to a big company these are, in fact, small deals. But there are multiple reasons why corporate IP spinouts are attractive

propositions for the parent corporation.

First, the parent participates in the technology’s future upside (through an equity stake) without being required to make any further capital investment. The standalone start-up leverages VC dollars going forward. The parent corporation – at no additional expense – may recoup its initial R&D dollars and potentially reap substantial rewards if the start-up blossoms.

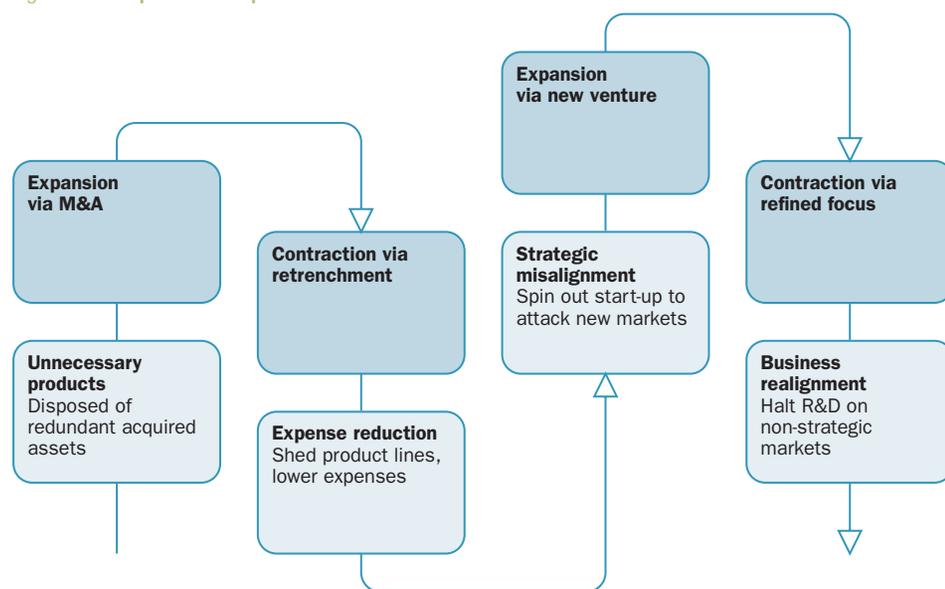
In 2006 the largest non-YouTube venture-backed technology exit was the acquisition of LANDesk for US\$475 million by Avocent. LANDesk began life as a spinout from Intel in 2002 with Intel retaining 15% ownership after the only round of outside capital LANDesk raised; Intel made US\$65 million to US\$70 million on this exit: not chump change. And perhaps the best example is Xerox. Xerox Palo Alto Research Center (PARC), for example, received equity stakes in dozens of early-stage projects spun out from its labs starting in the late 1970s. By 2001, Xerox PARC’s 10 most successful spinouts had a combined market capitalisation that was more than twice as large as Xerox’s own market capitalisation (see Figure 3).

Second, corporate IP spinouts enable the parent organisation to build up its technology ecosystem without exposing its bottom line. From the parent’s perspective, the spinout creates a natural partner for a customer, supplier, channel or OEM relationship. For example, imagine that a bank chooses to stop developing a home-brewed software application for regulatory compliance because maintaining software applications is not its core competency. Rather than abandon the project, the bank can spin out the team and the IP into a new start-up. The parent company receives bug fixes, feature upgrades and higher-quality customer support without diverting further IT resources to the project. On the flipside, the software start-up has a flagship customer and an instant revenue source. It’s a win-win situation.

Third, a spinout may offer a window into an emerging market – by sponsoring a spinout, the corporation gains learning and an opportunity to move into a new market if the spinout proves its viability. This is particularly true of research projects started in corporate labs; in many cases, the parent corporation doesn’t want to enter a nascent market directly, but via a spinout it can put its eyes and ears into an emerging sector.

Finally, corporations can realise less obvious but still valuable benefits from spinouts. Corporate IP spinouts enable the originating corporation to move the R&D

Figure 2. Corporate IP spinouts – motivations



expenses off its balance sheet and avoid future expenses while still retaining upside potential. They can also unlock potential tax loss benefits associated with earlier acquisitions by generating a tax realisation event if there have been some writedowns.

In terms of public relations, a corporate IP spinout is far preferable to shutting down a division and laying off employees. And, of course, if the key employees are committed to seeing the opportunity get into the market, they are likely to leave anyway; by structuring a spinout, the corporation retains value even after the people leave to go to the new venture.

Deal structure – unlocking the value

In a corporate IP spinout, the VC firm works with the parent corporation to extract key IP assets – including some of the people – into a new venture-backed company. The parent corporation and the VC firm bring different but equally necessary skills and assets to the table. The VC firm invests new money in the early-stage venture and recruits seasoned management to lead the start-up. In exchange, the VC firm receives preferred equity and a board seat. The corporate parent contributes patents, trade secrets and key engineers, typically receiving an equity stake in return. The corporate parent may also negotiate an ongoing channel or OEM relationship with the start-up as part of the spinout (see Figure 4).

What about university spinouts?

So how do universities compare to corporations as fishing ponds for early-stage venture investors? While some universities have a rich legacy as the source of leading technology companies, with Stanford as the prime example, investors have to consider the challenges, risks and benefits of university spinouts against those of corporate IP spinouts. Our experience in IT/software investments is that corporations are, in general, better sources for spinouts than universities.

When considering any spinout transaction, investors need to focus on four key elements of a deal: people; technology; deal structure; and engagement process. In our experience doing spinouts, all of these elements tend to favour the corporate model over the university one. However, we do not do life science or biotech investments: for investors who specialise in those areas, it could be a very different story. Figure 5 summarises our experiences with both types of spinout and why we favour corporate spinouts.

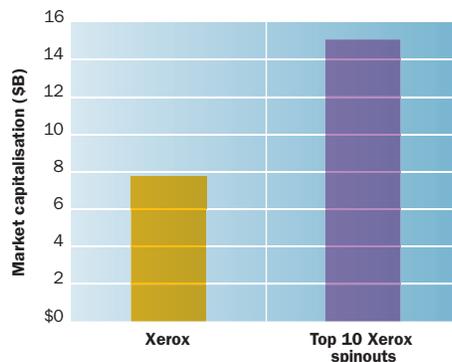
Patience is the key

Many technology companies, including IBM, NEC and Intel, are looking to corporate IP spinouts as another way to monetise their IP, and numerous venture capital firms are eagerly lining up with chequebooks in hand. But what should the parent corporations look for in a VC partner? Every VC claims to bring a strong professional network, exceptional technology skills and a sharp market vision, and to a large extent most do.

Perhaps the most critical characteristic required to lead a corporate IP spinout is patience. Transactions often require six to nine months from initial pitch to final closing. This timeline is longer than typical early-stage VC investments because spinouts involve not just two parties (VC and start-up), but three (VC, start-up and parent). Before a corporate IP spinout can be consummated, all three parties must agree on a multitude of issues including investment terms, IP licensing terms, employees, board rights and the parent/spinout ongoing relationship.

Unlike the fast-paced world of entrepreneurial start-ups to which VCs are accustomed, the world of large companies often moves more slowly and at its own pace. And the process is complicated by the reality that the key people for the start-up are usually still employees of the parent and the start-up company probably doesn't actually exist as an entity yet. Corporations should find a VC who understands the issues, is willing to spend the time and energy to work with them, has the fortitude and patience to oversee the process over an extended timeframe and can guide it to a close.

Figure 3. Market capitalisation of Xerox v top 10 Xerox PARC spinouts, 2001



Source: "The Governance and Performance of Xerox's Technology Spin-off Companies," Henry Chesbrough

Figure 4. Corporate IP spinouts – deal structure

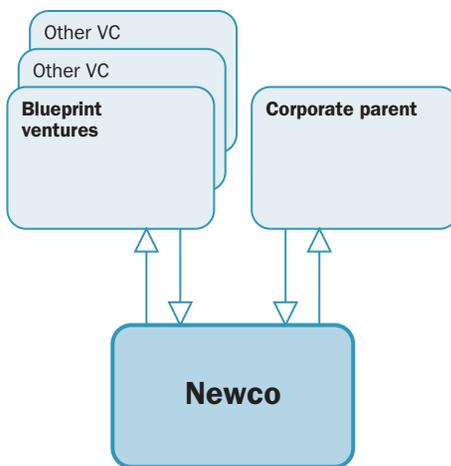


Figure 5. Corporate spinouts compared to university spinouts

Opportunity/ barrier	Corporation	University	Advantage?
Technology	Usually well-developed technology, but market opportunity not complete/correct	Technology is usually very raw – significant investment still required to prove the concept	Corporation
People	Technologists highly motivated to get their “baby” into the market and more attuned to commercialisation	Technologists are tenure track researchers, not entrepreneurs	Corporation
Deal structure	Corporations generally want equity over a royalty stream	Universities generally want royalties rather than equity	Corporation
Engagement process	Usually hard to find who has to approve and who could say no, but once found easier to do the deal	Nearly all schools have a tech transfer office, but motivations not always aligned with VCs	Unclear

Another requirement is a steely-eyed venture investor perspective. In evaluating these projects, the venture firm must be unshakeable in its quest for world-class technology. What looks like great technology spinning out of one company may in fact be inferior to that which is already being developed at one or more traditional start-ups or another large corporation. The venture firm must diligently work with many corporations as well as traditional entrepreneurs to find the best opportunities for venture investment. Unless the venture firm is continuously trolling all waters, it will fail to back the best investment opportunities.

Corporate IP spinouts are a great venture investment opportunity for VC firms, but they are perhaps an even better monetisation opportunity for corporations. Companies succeed by making their assets work for them. A corporation would find it unacceptable if its employees played truant or its cash reserves weren't bearing interest. Why should non-core intellectual property get a day off? Dust off those patents, regularly monitor which R&D projects are about to get cut in your lab and see how you can make your IP assets work for you. The arrow is already in your quiver, but you have to be willing to use it. ■

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