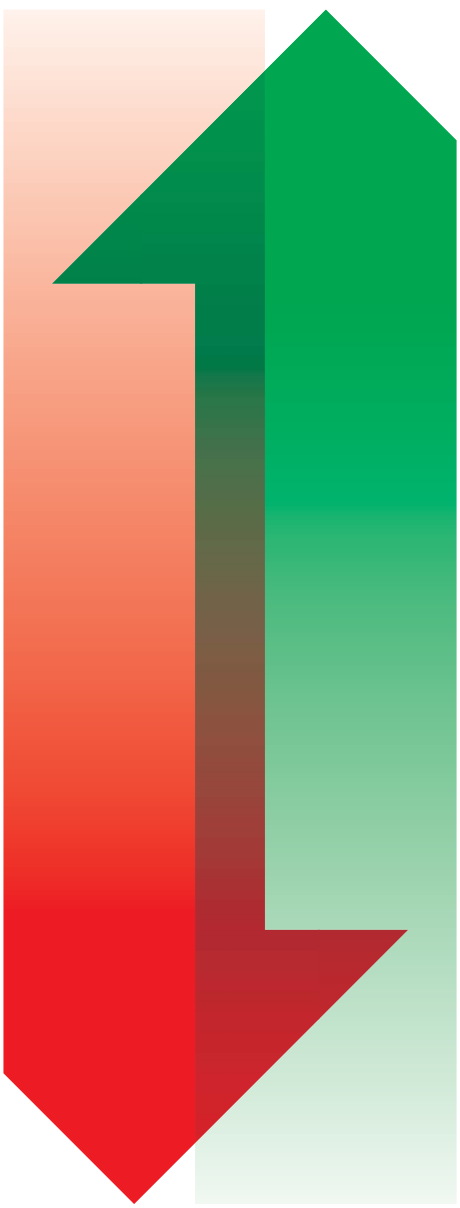
A flight to quality



The developed world is slipping into recession and established investment vehicles are crashing into disrepute. What will be the knock-on effect for IP assets – and those tasked with their management and monetisation?

By **Nigel Page**

With the financial crisis continuing to wrap its tentacles around the world, sparking a global liquidity crunch and massive risk aversion among investors, few commentators are prepared to make firm predictions about eventual outcomes.

But there is no shortage of speculation. Calls for a new Bretton Woods-style agreement to reform global economic governance are seldom out of the press and a prospective maelstrom of financial and capital markets regulation haunts banks, hedge funds and private equity firms worldwide. Meanwhile, institutional investors are taking stock of massive losses sustained from what were, until recently, considered to be safe havens for their capital.

Against this backdrop, the nascent IP monetisation communities are seeking to establish themselves. Given what has happened over the past few months, you could be forgiven for thinking that intermediaries and financiers alike are feeling pretty depressed. But, in fact, that does not seem to be the case. Although everyone acknowledges that these are difficult and uncertain times, the general view is that IP and intangibles in general may not only survive the storm, but may actually prosper. In fact, some predict this could be the beginning of a brave new world for IP's status as a steady, conservatively valued and uncorrelated asset class.

A new focus on IP portfolios

C-suite executives have long tended to overlook the untapped financial value of intangibles. But as market firestorms ebb and smouldering recession takes hold, many industry professionals believe that this is set to change. John Squires, chief IP counsel at Goldman Sachs, explains: "Certainly, where the financial crisis is concerned, we will see companies seeking to generate greater returns from their portfolios. If they already have exclusivity, then it will be incumbent on them to ensure that their patents can be relied upon to continue to provide this." Steve Lozan, VP of investments at Oppenheimer & Co, agrees: "Without doubt, some companies' valuations have been killed over the past weeks. And so, if they can sell their IP or license it, then they may now be much more happy to do so."

Fire sales of patents are widely anticipated in the short term, as executives in cash-strapped companies begin to view their IP as a source of operating capital – capital that can usefully be deployed to appease shareholders by compensating for dramatic drop-offs in revenues. Nir Kossovsky, chief executive of Steel City Re LLC, believes that this could be the case: "We should expect to see a lot more supply than demand. The whole notion of selling IP is more widely accepted than it was, so companies will seek to dispose of their IP via the markets. But I can't identify any real driver of increased demand. At the same time, greater uncertainty over asset-based and cashflow-based valuations will likely result in overall reductions in net present values of IP." That said, Kossovsky continues: "The value of the intangible

Challenging for new entrants

Though investment in IP as an asset class has grown meaningfully over the last five years, it is still nascent in its evolution. Analysis of historical returns remains difficult, given limited data. Therefore, it is challenging to predict how the current financial crisis will impact on attitudes of institutional investors and the development of the asset class.

IP is viewed as uncorrelated to the rest of the financial market, making it an opportune area for investment by institutions that seek diversification and reduced volatility. In fact, over the last nine months – during the eye of the storm – our fund has had three substantial realisations. Historically, IP exploitation has been counter-cyclical as IP assertions have increased in recessionary environments. In addition, a variety of models have emerged for investment in IP. Their emergence shows an increased awareness in the market of the standalone value of IP.

However, during times of great dislocation, investors often flock to liquidity and perceived safety. Given the opaque nature of the asset class, IP will be challenging for new investors. The overall deleveraging of the financial system will result in the elimination of many hedge funds and other financial institutions' tolerance for risk will be curtailed for the foreseeable future. Rather than invest in a new and illiquid asset class, with the public equity markets down approximately 40% year to date, investors may find liquid investments more attractive relative to other investment opportunities.

At Altitude, we have positioned ourselves as a well-capitalised liquidity provider that can serve the needs of many different stakeholders in the IP ecosystem. In these uncertain times, we expect to be more productive than ever before. Our crystal ball suggests that in the next six to 12 months, capital formation will be considerably more challenging for new entrants. If it flows at all, it will be directed to players which have demonstrated their capabilities and infrastructure to succeed in a world that is changing daily.

Amar K Mehta, partner, Altitude Capital Partners

asset 'integrity' will become hugely inflated. So IP that has integrity will maintain and increase its value, being seen as less risky and more secure. In many ways, this will be analogous to the way Treasuries are viewed as less risky and more secure credit instruments in a financial crisis."

Ron Laurie, managing director of Inflexion Point Strategy LLC in Silicon Valley, believes that demand for high quality patents will help to safeguard their value, but he is less sure about those further down the scale: "In the new financial environment, high quality patent properties will continue to command eight figure prices, while patents in the mid-range portion of the quality spectrum will be heavily discounted and demand at the bottom end of the market will likely disappear altogether."

For his part, Bruce Berman, CEO of Brody Berman Associates in New York, believes that there will be deeper understanding and respect for IP assets as a result of the financial crisis: "Derivatives investors thought that by continually transferring risk they would be spreading it. Instead, they hid it. There is now a better awareness in the asset-backed markets that scrutiny of ownership is a good thing. Patents subject to sale or investment are highly scrutinised and conservatively valued. This will translate into a new-found respect for the in-depth analysis and caution that IP investors bring to bear." Berman says he believes that prospects for the IP industry generally are good. "There's no sense of panic that I'm aware of and IP as an asset class is still very much in growth mode. As markets continue to plummet, investors will be forced to focus on maintaining their holdings, not flipping them," he explains. It will, he continues, be much less about income statements for the foreseeable future, and more about asset values. "Although IP is still being swept into 'goodwill' in the US, we may well see this re-focus on asset stewardship leading

> “There’s no sense of panic that I’m aware of and IP as an asset class is still very much in growth mode”

No collapse in the market for ideas

What we are witnessing today is the popping of an asset bubble and the associated worldwide unwinding of highly levered positions by entities across the investor spectrum. Banks, insurance companies and investment funds built their businesses in part on the belief that many hard assets – most notably real estate, the ultimate tangible asset – would never suffer a drop in pricing. Now that this faith has been broken the question on everyone’s mind is: what is the value of tangible assets? The market is trying to find an answer, but doing so is proving painful. And while this question remains, companies are asking how they can outperform competition, maintain value, protect market share and generate a return on their investments. Unlike typical tangible assets, patents, trademarks and know-how are the only form of true protection against a drop in value.

The collapse in tangible valuations leaves only one asset class available for a reliable collateral backstop – protectable intangible assets. Regardless of the path taken by the financial markets, there is no decline in the supply of, or demand for, ideas. Moreover, companies still need to borrow and investors still want to earn a return. Therefore, market demand will encourage monetisation strategies that include more IP-backed lending, licensing and auction and private sales than in the past.

In addition to an increase and evolution in these strategies, there will also be revolutionary new strategies that investors will utilise. I believe we will see the rise of such things as transparent trading platforms for technology bundles and investment vehicles focused on using intellectual property as a signal of company value.

Regardless of which strategies dominate in the future, it is clear that companies rich in intellectual property are best positioned to take advantage of the changing financial landscape.

Andy Carter, managing director, Ocean Tomo

to IP being shifted onto the balance sheet – where it belongs,” Berman concludes.

If predictions of increased patent sales as a result of the crisis are proved right, then Ocean Tomo’s auctions should benefit. In its most recent IP auction, held on 30th October in Chicago, Ocean Tomo generated a total US$12.84 million – slightly more than it raised in the equivalent sale in 2007. Managing director Andy Carter is optimistic for the future: “Given that we may be in a recession, managers will be forced to focus on the core values of their companies – and, in many cases, this will be their IP. Also, when times are bad, that can be the best time to buy assets to shore up the core of your IP portfolio.” Carter expresses no concerns about a possible drop in IP value as a result of supply outstripping demand: “Will IP as an asset class be worth less in the future as a result of what we’re experiencing now? No. Valuations of IP are built on future expectations and the future need for and drive to create, innovate and invent has not fundamentally changed.”

Licensing activity is set to pick up too, many believe. “Companies that rely more on a licensing model will want to work their portfolios to ensure that this can continue to deliver value,” says Squires. “That said, there could also be some more speculative IP assets out there that licensees will be reluctant to take advantage of in the current climate.” Typically, he explains, events in the IP domain tend to lag those in the broader economy, so these developments may take some time to make themselves felt.

If companies are to get full value from their patents at a time when they desperately need to be able to do so, a number of changes will have to be forthcoming. In the US, practitioners agree that one priority must be for the USPTO to reduce the current pendency time. “This is divorcing these rights-gathering regimes from the actual marketplace and limiting the ability of companies to deploy their IP assets,” claims Squires. If companies are to

An onset of pessimism

In this environment, real estate asset evaluation is considered to be an extremely risky process. What effect will this have on market perceptions (and valuations) of IP assets?

Dependent on how strong the after-effects of the financial crisis are, there are two possibilities. Either the IP sellers market will almost completely break down for some time, in the absence of more strategic buyers (like Coller IP Capital); or there will be a major new focus by CFOs on their companies' intangible assets (with the aim of monetising existing IP positions).

We believe that the latter is more likely to happen. For acquirers of IP, a potentially more effective route, however, would be to consider all-out corporate acquisitions (especially if opportunities exist to acquire smaller public companies whose share price is depressed).

If liquidity becomes short for a while – or if a long-lasting recession takes place – companies will most likely react by toning down R&D activity. If this happens, they will generate less valuable patents and/or cash in parts of their IP portfolio. That would result in a buyer's market for IP.

If more IP holders try to go for licences, then they will all eventually have to share in whatever money is available. To argue by extreme extrapolation: we cannot imagine licence payments going up by a factor of 20 throughout industry. The resulting inflation would force a change in legislation.

Therefore, this kind of activity will most probably be limited. The story is different where weapons of defence are concerned. If the trolls force licensing too much, or if they become too many, the problem of trolls will find a solution in legislation (a process that is already underway following last year's US Supreme Court decisions).

Independent of the financial crisis, it looks as if we could see an IP asset bubble over the next five to 10 years, followed by a change in IP legislation. It is already impossible today to clean a complex technology of external IP, or at least to assess and quantify the risk of stepping into a trap. The number of worldwide patent applications is growing rapidly and with the coming more widespread use of IP rights (to make money) and a changed risk perception among investors driven by the financial crisis, a doom scenario can be imagined where high-tech investment comes to a stop.

It's autumn, it's getting darker and these bear markets can lead to an onset of pessimism.

Severin de Wit, IPEG Consultancy BV, The Hague (Netherlands)

be able to extract maximum value from their IP portfolios, he says, then a much swifter examination process is necessary. "The current lengthy pendency period is also preventing licensees from getting full value from a licence - after all, as things stand they are really just being given an option on a patent's use, to put this in derivatives-based language."

Added investor interest

A number of trends are driving hedge funds and private equity funds towards a deeper awareness of IP. Over in Silicon Valley, Ron Epstein of IPotential reports seeing an increased focus by banks and venture capital funds on investing in IP as a means of recouping the bridging loans they made to tech companies. "As people withdraw their money from traditional investments, we've seen no slackening of interest in patent purchasing," he explains.

There is now every indication, Epstein says, that having started to view patents as capital assets, investors (including hedge funds and private equity funds) are looking at how to channel money into IP. "The market is liquefying now and, as this happens, investors are becoming increasingly interested in it," he concludes.

Ron Laurie expects to see some of these investors looking at arbitrage opportunities in acquiring high-value patent portfolios at fire-sale prices and then re-selling when the market comes back. This is in part, he explains, driven by the need to deploy the large sums of capital that they still have under management. However, he continues: "The central issue will be whether they can get comfortable with the level of risk uncertainty that characterises the patent market, due to the limited price discovery mechanisms — for example, comparable transaction data — and to the inherently unique nature of patents."

Coller Capital is a leading investor in private equity secondaries, with approximately US$8 billion under management. A private equity firm itself, Coller acquires positions in venture capital, buyout and mezzanine funds, together with portfolios of companies or stakes in companies. Peter Holden is the partner who heads up the firm's IP Investment Group. He expects to see many more patents coming to market - a positive development for his business, which focuses on acquiring and leveraging large portfolios of IP from leading corporations: "We've had a securities crisis and a credit crunch, and we're just now starting to see significant pressure on corporate earnings with the effect that firms will look more to the near-term sale of non-core assets as a means to meet their quarterly targets."

In the first instance, he says, a lot of these sales will dispose of lower-quality patents – such as those marked for abandonment. But as they continue to look to plug deficits in earnings and discontinue non-core or underperforming business activity, a secondary cycle will develop where higher-quality patents, and in greater numbers, will start to come onto the market. Holden references several third-party efforts at sizing the IP trading marketplace that show a range of annual global purchases of patents, either directly or intermediated, ranging from US$1.5 billion to US$2 billion last year. He expects to see these (probably conservative) estimates rising by between 20% and 25% over the next few years, with the slack from corporations being taken up by a new generation of financial, quasi-governmental and private pool patent purchasing entities.

The need for a valuation standard

Underlying contributors to the financial crisis have been shown to be certain types of financial innovation and a lack of transparency. This, most commentators agree, could well spur an intensifying focus on IP valuation methods in the months to come.

Whether or not a valuation standard is feasible is another matter. Although most agree that the existence of a standardised and agreed standard for patent valuations would go some way to building the level of investor confidence in this asset class that could help it grow, the obstacles that stand in its way are well recognised.

There are a number of initiatives underway geared to creating some kind of valuation standard for intangibles, but any widely accepted system still remains some way off. Andy Gibbs, the CEO of PatentCafe and chairman of the Intangible Assets Metrics Committee of the Intangible Asset Finance Society, puts the efforts in perspective: "I don't think that we should expect to see any mechanism for calculating the economic value of intangibles – for one thing, I can't see any hope of the underlying algorithms being agreed by the key players." And even if they could agree on an economic model, it would have to reflect the wider global economy. That, says Gibbs, is just too volatile right now. However, there are some changes afoot, he believes: "The market is heading towards a system that will allow for a universally accepted method of establishing a qualitative value and converting that to a quantitative measure."

Epstein agrees that a valuation standard will be almost impossible to achieve: "I just

Patents and patent managers: shining stars in a dark economy?

In 2001, Baruch Lev, professor of accounting and finance, Stern School of Business, New York University, forewarned: "Investors have something to lose … if investors don't know about intangibles, they are going to assume the worst. In capital markets, no news is bad news."

Paradoxically, a 2001 FASB Report created an intangible asset reporting loophole, noting: "Companies' inability to identify and inventory intangible assets may be the most significant obstacle to any comprehensive recognition of intangible assets."

Although PricewaterhouseCoopers showed that 70% of the market value of the S&P 500 companies was attributable to intangible assets, Adams (Trevejo-Darko, Adams and Bouchard, "Intangible Compliance: Capturing Overlooked Value", *Les Nouvelles*, March 2008) concluded: "The average ratio of reported intangibles [reflected] a non-compliance level of 91 percent! In any other category of financial compliance, such a level of non-compliance would not be tolerated."

I believe that a host of shareholder derivative suits will cite declining stock value reflecting C-level executives' mismanagement of the tangible assets; and that will be despite their use of mature accounting systems and legions of finance and accounting professionals. Alarmingly, these mismanaged assets represent only the subordinate 30% of market cap value.

How, then in these dark days of collapsing economies, can CXOs demonstrate effective management of the other 70% of shareholder value; specifically, intangibles?

The financial world may finally be ready to recognise patents and patent managers as tomorrow's shining stars of asset management.

Patent portfolio management software, and objective patent quality rating systems, introduced after the 2001 FASB Report, are deployed today by the most forward-looking corporations. By using computed quality metrics (as a proxy for the economic value of patents and portfolios), the quality of a patent portfolio can be measured and reliably managed.

In fact, computed data directly supports management decisions related to today's most urgent corporate objectives: slash costs and increase revenue. Day-to-day tasks include patent acquisition, portfolio pruning, assertion and licensing campaigns, accelerating R&D and gathering competitive business intelligence. Custodians of patent assets are exclusively positioned to deploy these tools, bringing effective intangible asset management to the forefront of corporate asset management and reporting.

In a spirited debate at a recent conference, a few senior IP counsel said they would use "people, rather than tools" to provide patent portfolio due diligence and evaluation. The notion that "people" could provide objective and complete analysis of portfolios containing thousands of patents within a fiscal quarter, let alone annually, was strongly challenged by those now using software tools. Arguably, non-use of available patent measurement solutions could constitute willful negligence.

The undeniable fiduciary responsibility of all CXOs is to create, protect and grow shareholder value. The failure of CXOs effectively to manage tangible assets has created an opportunity for the chief intellectual property officer to have a profoundly positive impact on shareholder value.

As chief patent custodians are elevated to key corporate asset management positions, their ability to create shareholder value is met with corresponding shareholder accountability. The new shining stars will be noticed.

Andy Gibbs, CEO of PatentCafe and Chairman, Intangible Assets Metrics Committee, Intangible Asset Finance Society

Implications of the coming downturn for the IP services industry

Times of economic uncertainty present significant risks to all participants in an industry. Less well understood, perhaps, is that market turmoil presents the opportunity for stronger, more aggressive players to gain share and restructure the rules of competition. The IP services industry, looking into 2009 and beyond, will be no different.

The pressures that our clients (in ThinkFire's case, primarily technology companies) are facing will clearly have an impact on our industry's growth and profitability. As companies seek to conserve cash, they will take a hard look at all areas, including their IP and legal departments, in an effort to reduce or eliminate some or most discretionary spending and defer investments in areas that do not yield a quick payback in terms of revenue or profit upside. The pressure on IP departments to cut costs will be exacerbated by the fact that, in most companies, there is limited understanding on the part of business executives about the role and value contribution of IP in helping a company meet its financial and strategic objectives; that is, most of what is done in the IP department probably appears to be discretionary, non-value adding activities. IP service providers can expect to face significantly reduced demand and downward price pressure for the portfolio assessment, valuation and strategy services that they have traditionally provided.

The upside, of course, is that many companies that have historically avoided selling and/or licensing IP will be more open-minded about these cash-generating activities as a way both to reduce some of the budgetary pressure that IP departments will face and to justify the department's role as a critical, value-adding part of a company. It will not be easy. For patent sales, there will be fewer buyers and they will have a focus on quality and lower prices. Patent licensing, even in the best of circumstances, is uncertain and risky; and technology licensing, while not adversarial, is a time-consuming process that yields little short-term benefit. One potentially overlooked area is trademark licensing. Deals can be concluded relatively quickly and can be structured in a mutually beneficial manner. They can bring incremental, high-margin cashflow to the licensor and an opportunity to gain share in turbulent markets for the licensee.

We in the IP services industry have a great opportunity to help our clients navigate through these treacherous times. With our expertise and advice, we can help IP departments make the best possible trade-offs between short-term cost reduction and monetisation pressures, and the need to maintain, develop and exploit an IP portfolio that meets the longer-term strategic and operational needs of the business. Those IP groups that get it right will clearly be seen as major contributors to their company's near-term profitability and cashflow, and to the creation of sustainable market value. Those IP service providers that prove to be most adept and cost effective in helping their clients accomplish this will be the winners as well.

Steven J Hoffman, president and CEO, ThinkFire

don't believe that IP is an asset class that lends itself to any standardised valuation methodology. I am not aware of any asset class that has an objective valuation method – all are dependent on markets where subjective variables play a critical role. Even in the currency markets, valuations depend on a number of subjective measures, such as the potential effect of debt and inflation, and patents are so much more subjective."

But other practitioners are more optimistic. Professor Alexander Wurzer, Director of the Institute for Intellectual Property Management, Steinbeis-University, Berlin, is one: "I am working with the DIN (German Institute for Standardisation) for the German Ministry of Economy on a research and development project about patent valuation standards. A year ago, we offered our first proposal for such a standard to the US and were told that nobody needed it. Now the financial crisis is changing all that."

Some expect the US Court of Appeals for the Federal Circuit's recent decision in the *Bilski* case to have a significant impact on valuations. Goldman Sachs' Squires is one of these: "The decision in *Bilski* could mean that from now on there will be a premium placed upon innovations that are built out, versus paper patents. This could favour more of an incubator model for companies. In other words, we will see valuations becoming more closely correlated to underlying products and services."

Driving to transparency and real IP

The crisis has prompted widespread discussion of the merits, or otherwise, of fair value (mark-to-market) accounting as the means by which the value of complex financial assets held by banks, insurers and other companies should be reported. What differentiates fair value accounting is that it requires companies to mark-to-market financial assets such as securities and derivatives, and to value them at the price at which they could be sold, rather than at the cost for which they were acquired. In the recent credit market conditions, the market

> “Greater transparency around IP would certainly generate more value as there would be less perceived risk attaching to IP assets”

for many of these assets shrank or virtually disappeared, forcing many banks and companies to make massive write-offs.

Although critics of fair value claim that its measurement requirements can produce inaccurate or arbitrary results under unusual market conditions, investors are generally in favour. This is largely because of the added insight fair value accounting provides into a company’s current financial situation. The wider argument now, in light of global calls for transparency, is whether fair value could or should be extended to other non-financial assets, including intangibles. Ocean Tomo’s Andy Carter observes: “It may be true that these accounting rules caused some companies and banks to fail. But I personally don’t think that this was the case. And if wider application of these rules were to [embrace intangible assets], I believe that greater transparency around IP would certainly generate more value as there would be less perceived risk attaching to IP assets.”

The expected upsurge in patent sales can, most agree, only be a positive development, helping to create a much more liquid IP market. This will, in turn, enable much clearer and potentially higher valuations. “During this financial crisis,” says Oppenheimer’s Lozan, “the price of mortgage bonds decreased in part due to the lack of liquidity. Liquid markets in IP are only now starting to take off and these can only lead to increased visibility and potentially higher values.”

It looks likely that we will see a derivative model of IP emerging, where the

A wonderful buying opportunity

IP as an investment-grade asset class is, of course, not immune from the financial crisis and the impending corporate earnings erosion. But at the same time, there are some counter-cyclical aspects to IP investing that are very compelling.

On the supply side, I see leading global corporations increasing the quality and quantity of their sales offerings for two reasons: in order to create liquidity to meet business unit or corporate-wide earnings targets; and to de-risk their IP monetisation programmes with outside capital partners and management teams.

On the buy side, corporations will engage in smaller, more tactical acquisitions to fill in shorter-term holes in their portfolio or for counter-assertion purposes with an immediate impact on their businesses, rather than the larger, longer-term and more strategic plays. As with R&D expenditures, though, Japan and Korea (and more recently Taiwan and China) will continue to acquire IP actively with a longer-term perspective in mind; while US and European firms – that are more quarterly earnings-driven – will have reduced IP acquisition budgets.

Price inflation on patent purchases, fuelled by the increased intermediation of IP transactions (though high-end transactions will continued to be managed directly by corporate sellers) and increased demand, will level off considerably in 2009. The financial crisis is forcing fringe buyers, such as hedge funds, banks and PE firms, to retrench from speculative IP investing to focus on asset triage and core activities instead – we have started to see a flush of sales from these entities recently. This is somewhat offset by increased activity by global sovereign funds and government initiatives in the Middle East and Asia, particularly those that may have a regional economic development rather than a pure market-driven focus.

In short, we see this as a wonderful buying opportunity, while recognising that the gains one may make on cheaper, better-quality assets will be metered by the longer runway and increased management costs required to leverage these assets – at acceptable levels of ROI – subsequently in the marketplace.

Peter D Holden, partner, IP Investment Group, Coller Capital

The above are personal opinions which do not necessarily reflect those of Coller Capital and its investors.

The vital role of insurance

Experiments of nature are epistemological gifts that test our models of the world without the nasty morality bits. We could never have purposefully tested, for example, the market consequences of suddenly transforming conventional balance-sheet assets, tangible assets, into intangible assets. Anyone owning equity securities and paying attention will appreciate that this has now been done and we have the answer. First, the markets will struggle to establish value. This will manifest as unprecedented price movement and record-breaking volatility. Second, market authorities will seek to communicate value through non-conventional channels and proxies. This will manifest as political and economic summits and policy pronouncements. The markets will respond with hope followed by a period of reflection. The effects of reflection depend on the strength of the markets' belief systems. These, it appears, have been battered by political dithering. Irrespective, the fluff best be followed quickly by substance because markets respond poorly to missed expectations.

This brings us to the third piece, which is action by the authorities to establish value by proxy. So far, this action is taking form in guarantees and capital infusions. The guarantees, such as raising the insurable limits for deposits or underwriting inter-bank loans, seem to be doing their part in restoring confidence, another key intangible. This affirms a central role for insurances in intangible asset finance. Fourth and last, the authorities will develop business processes to manage and create value better in the mortgage instruments underlying the derivatives.

In keeping with its mission of education, advocacy and the promulgation of asset management best practices, the Intangible Asset Finance Society audaciously proposes a theory. Here it is: to create or protect – that is, insure – value in the intangible assets, such as safety, security, quality, integrity, sustainability and innovation, which underlie reputation, intangible asset financial stewards must: (i) manage the business processes underlying these assets; (ii) use an independent financial metric (index) or other proxy to provide measurements for that which is being managed; (iii) signal the reasonable value of these assets; and (iv) deploy insurances to increase stakeholders' confidence in the signalled value.

And a final thought. In 1970, Joni Mitchell's *Big Yellow Taxi* advised: "Don't it always seem to go, that you don't know what you've got till it's gone." We now know the collective value of the intangible assets that drive the reputation of the global banking system: US$30 trillion.

Nir Kossovsky, chief executive,
Steel City Re LLC and executive secretary,
Intangible Asset Finance Society

most valuable IP will be recognised as that which derives its value from commercialised products or services. This, in turn, will mean that companies will have to be able to show that their IP is properly aligned to their overall business strategy. Many agree that, as a result, this could be a defining period. Companies will have to be smarter about IP management and boards will have to get more involved in IP. And conversations between both camps will have to get much more sophisticated.

This focus on real-world IP will be intensified by the financial crisis. Investors will attach greater value to rights that work and have not been removed from their creators. Michael Martin is a private investor in IP, based in Palo Alto. Since the Bayh-Dole Act, he explains, there has been an increasing trend in the US towards the separation of patent ownership from the teams that actually did the work in creating the IP: "We have a lot of universities working with corporations, with companies investing in commercialisation in exchange for patent rights. But that dynamic – where rights are removed from the original inventors – is responsible for a lot of the dysfunction that we're seeing." Patents, says Martin, can't just be taken and used. Instead, a lot of collaboration is needed to make them deliver value. "If licences are to be transferred in the secondary market," he continues, "then there needs to be some know-how involved as well – all of us would prefer to see patents come in a package that offers a value proposition to licensees."

Using the capital markets

With the shattering of confidence in many financing structures built upon tangible assets, most commentators expect to see companies putting their IP assets more to the fore to prove that they have valuable collateral backing them up. Harder IP assets, such as patents, are likely to be favoured and, with a lot of capital rumoured to be waiting on the sidelines for a good home, there seems little doubt that companies with well-defined IP portfolios will be best placed to take advantage. "From now on, investors are going to be a lot more demanding," says Squires. "Companies will have to be able to show that they have robust IP portfolios and this, in turn, will call for more and better due diligence by IP professionals."

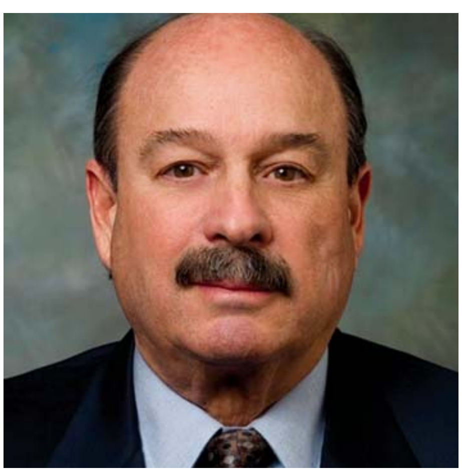
Andy Gibbs also expects there to be no shortage of capital – and no drying up of IP financing mechanisms. "Notwithstanding the meltdown we've been seeing, the financial mechanisms that have evolved in the IP industry will continue to operate," he says. He explains that this is because all of the markets that are collapsing now are based on tangible assets, such as commodities and real estate. With money being withdrawn from those markets, an inordinately large pool of capital is being freed up for investment elsewhere. "Put simply, with tangibles temporarily off the map, intangibles are set to become very hot property," Gibbs sums up.

For a while now, the asset-backed securities (ABS) market has been moribund. Jay Eisbruck of hedge fund Serengeti Asset Management — and formerly managing director in Moody's Investor Services' Asset-Backed Finance Group — expects that while some of the deals that got done previously will come onto the secondary market, the new issue market will be quiet for some time yet. "It's hard to say what the longer-term effect will be on structured IP financings. Without doubt, it will take some time for the market to come back - the same as it will for other types of securitisation deals. The capital markets need to calm down before we can see a way ahead," Eisbruck says.

For his part, Andy Carter believes that the importance of intangible assets to companies will help to ensure their value is maintained and leveragable: "Until recently, we saw people putting blind faith in the rising value of property. But logically, why should houses have been selling for so much more than the value of their component parts? With companies, the principal source of value has been proven to be intangible assets and these are still seen as solid and conservatively valued." While a collapse in the tangible value of homes was probably long overdue, says Carter, it is unlikely the same thing will happen with regard to IP-backed lending. "I would expect that to increase - ideas are what matters and, from now on, innovation is the one area where the US must really look to compete on the global stage," he states.

Carter goes on to point out how innovation, measured in terms of patenting activity, is generally not affected by economic downturns. He observes that patent filings per capita in the US were stable from the late 1800s until World War Two and then again from after the war until 1990. "During those periods America saw booms, busts, bubbles, panics and numerous technology and market shifts," Carter says. "Yet patenting activity was fairly stable. Why? Because there is a

Effect of the financial meltdown on the patent trading market



Since the credit freeze and resulting equity market collapse began in early October, there has been a lot of speculation in intellectual property circles about possible implications for the nascent but rapidly expanding market for buying and selling patents. So what will be the likely effects of the pain in the debt and equity markets on the patent trading market?

On the supply side, larger corporate patent owners unable to finance operations via commercial paper and other short-term debt, or mindful of the effect of an anaemic income statement on their stock price, will turn to their patent portfolios as a source of operating capital. This will increase the number of patents available for acquisition and will drive prices down as patents change hands under fire-sale conditions. Obviously, the first to go will be patents that are not core to the owner's business or which do not provide defensive protection against competitors with aggressive licensing programmes. In addition, smaller venture-backed companies may sell their patents in exchange for a defensive grant-back licence and cash in order to get them to the next financing round.

On the demand side, there are two potential drivers. First, because patent litigation between commercial rivals tends to be counter-cyclical, more high-value patents will be acquired by operating companies to settle litigation or deter attacks by commercial rivals. Second, institutional investors that have substantial sums under management but have soured on the credit and equity markets may turn to patents as a new alternative investment asset class. Even before the financial meltdown, a number of patent funds were financed, in whole or in part, by institutional investors, including Intellectual Ventures, Altitude Capital, Rembrandt IP Management, NW Patent Funding, RPX and IPCom. The question is whether institutional investors will accept the limited liquidity in the patent market and the lack of reliable valuation methodologies for assessing the various types of risk discount applicable to patent value such as invalidity risk, design-around risk and narrow claims construction risk. To the extent that these sources of risk uncertainty can be reduced, or at least managed, more institutional money will flow to the patent trading market and to companies that are players in that market.

Ron Laurie, managing director, Inflexion Point Strategy, LLC

New IP business models could struggle

First, it is important to distinguish between investments made in IP for the purpose of increasing the equity value of a company versus investments made in IP for the purposes of generating revenue from other companies using the technology. The former will decline at many companies because of the weakness in credit markets, which makes R&D more expensive for most companies. The latter presents a more complicated story.

IP in the form of patents has already been established as a viable source of revenue in the biotech and pharmaceutical industries in which the present value of exclusive rights (eg, to sell a particular medical device or drug) can be valued in the hundreds of millions of dollars. The success of private equity firms in these markets, such as Paul Capital and Royalty Pharma, may even accelerate through the current financial crisis as some institutional investors may begin looking for sources of cash flow outside of traditional fixed-income securities.

In other industries, transaction costs associated with the financing, development and transfer of IP have traditionally amounted to a more substantial proportion of the expected value of the IP. In these industries, investors and company managers have typically ignored IP until much later in the cycle of development of new products or services, or at least until a point in time at which the present value of exclusive rights could better be estimated. Over the past 10 years and continuing on today, however, the transaction costs of IP procurement have been declining. This is largely due to the dramatically reduced costs of communication and search made possible by the internet. We are now arriving at what is perhaps the first moment in history in which it will be cheaper for companies in any industry to identify and acquire or license IP *ex ante* rather than building their business and defending against patent infringement litigation *ex post*.

Unfortunately, the current financial crisis will be a headwind against any IP-based business models that are new to a particular industry. Given the current litigation-driven dynamics, any new player in these markets will have to operate at considerable scale and the backing of institutional investors necessary to achieve such a scale is going to be difficult as many of these institutional investors are suffering from major losses. On an optimistic outlook, the current players such as Intellectual Ventures and Paul Capital will generate high enough returns to generate excitement about new entrants. On a pessimistic outlook, IP-based business models will suffer terrible returns as royalty streams dry up along with the revenue of entire markets as the financial crisis spreads to the rest of the economy, including the technology markets. I tend to be optimistic because I believe that market crashes tend to create opportunities for good companies at the same time they bankrupt bad companies. But the dynamics are far too complex, and changes too fast-moving, for any predictions to be reliable.

Michael Martin, founder, Venetian Capital Management

constant demand for innovation, regardless of the short-term fluctuations of the business cycle. So, barring a world war or other calamity, the supply of intangible assets to the markets is not set to contract."

Alexander Wurzer agrees that it would be wrong to write off IP financings via the capital markets: "In the wider market, people invested in assets which they didn't understand. Mortgages are obviously something solid from the physical economy, but the investment products themselves were strangely configured. What I think will happen, and what we're already seeing among banks in the US and in continental Europe, is people being increasingly keen to understand what IP assets have to offer. They want to understand the risk structures of these assets and I'm convinced that this greater interest will stay."

Innovation doesn't stop

Innovation is a constant. Patenting activity is not impaired by economic downturns – and neither is financial ingenuity. Marc Lucier is a director at Deutsche Bank in New York focused on asset finance investment and risk transfer involving intellectual property and other intangible assets. He also reports that activity in the ABS markets has slowed to a crawl, but points to other initiatives where his team is currently involved: "We're working on a number of different opportunities, some of them involving the capital markets for IP-related risk transfer, supplementing what has already been done in the insurance markets. And overall, and notwithstanding all the turmoil out there, we're optimistic about the products we're developing."

Lucier explains that risk is a major underlying theme in much of his work, mainly advising Fortune 100-type companies. He continues: "These clients are not looking at funky IP-based financings to raise capital. But they are very aware of and concerned by risk exposures. The fact that even Berkshire Hathaway has seen its credit default swap spread increase by nearly 100 basis points since the beginning of October underlines just how risk-averse the marketplace has suddenly become."

In the capital markets, one way of achieving risk transfer for property and casualty losses caused by natural disasters has been via catastrophe bonds (or cat bonds). With these instruments, the insured retains some risk, insurers take the next level and the cat bonds cover the rest. Although this is still not a huge market, it is growing. But, Lucier points out, this growth did not start until a methodology was developed for predicting damages. "That's something we still don't have for patent infringement-type liability - and there will be problems involved in arriving at this sort of methodology," he says. "Another obstacle is the fact that moral hazard with patent infringement risk exists to a far greater extent than it does with hurricanes. So this is limiting the capital markets' interest in IP risk right now. In other words, they still don't know how to model it and they need to find a way of mitigating the high degree of moral hazard."

As a result, Lucier continues, it has been impossible to carry out pure IP risk transfer - so his team has been focusing on developing products that go as far as possible towards this objective: "There is definitely interest in uncorrelated and innovative investment opportunities where investors can identify some long-term potential. In the long term, because of the fundamentals of IP as an asset class, I'm optimistic it won't be affected by the crisis. Indeed, IP will attract greater interest precisely because of its fundamental role in driving value in our economy."

The attraction of royalty

As companies seek out alternative routes to capital raising, certain players in the IP finance community appear well placed to take advantage. "The financial crisis will slow down some areas of IP monetisation a lot," claims Michael Martin. "But there will be exceptions — for example, the biotech market where the royalty streams are relatively easy to quantify. To the extent that the funds already operating in this secondary market can point to consistent royalties, they should find it easier to attract investment."

Royalty Pharma is one such player, investing in royalty streams in the biopharmaceutical industries. Its senior VP, Mike Herman, sums up the business climate: "Sales of royalty streams are increasingly being looked at as a real alternative to raising equity capital. Because the method of financing that we provide is product driven, not market driven, it remains very consistent. This means that companies can use it to access capital, whether or not their stock price is depressed and irrespective of market fluctuations."

Focusing on human healthcare, Royalty Pharma currently holds around US$5 billion in assets. Its business model centres on buying up royalty streams flowing from products in the pharmaceutical and biotech industries, providing liquidity to their owners and assuming the ongoing risks and rewards. Herman maintains that the business has experienced a significant uptick in activity since the onset of the financial crisis: "With cash levels so low and the need for funding so robust, we've noted that people are getting much more interested in what we have to offer."

Structured as an evergreen fund rather than as a series of closed-end funds,

Problems for non-practising entities

The financial crisis itself would have had a negligible effect on intellectual property matters. However, the broad-based global recession that is underway, and likely to deepen, will significantly impact on intellectual property practices over the next several years:

- Operating companies will seek to enforce patent rights as a means to bolster sagging profits (notwithstanding the fact that, given the three to five-year period required to resolve patent disputes involving sufficient royalties to have a material impact on large company P&Ls, such efforts may in fact diminish near-term profitability as enforcement costs are incurred – a reality too often overlooked).
- With diminished sales of products and services, the amount of royalty due under existing or new licences will diminish. The result will be that non-practising entities (NPEs), relying primarily on contingent law firms, will experience greater difficulty arranging for contingent representation.
- Whether patent assertions are by operating companies or NPEs, they will face a more hostile and less receptive audience, significantly extending all but small (sub-million US dollar) settlements, even for robust assertions, as companies seek to preserve their cash and profitability.
- Those companies with technology leadership and differentiating, proven know-how may find a more welcoming licensing environment for technology transfer as companies seek to reduce their own R&D expenditures, while simultaneously gaining access to features and functions that may improve their ability to win more business in a shrinking market. But the licensor must be patient to participate in the upside (rule: patient, win-win deals will gain from the downturn).
- Companies with excess patents will seek to divest portions of their portfolio, as will failed and failing companies. Allied Security Trust will benefit from this occurrence given its ability to combine funds to purchase patents, or licences to patents, that may otherwise fall into adversarial hands. Sellers will benefit from a robust market that will remain for patents of interest to companies most targeted by NPEs (high-tech, financial services, medical devices and retail).

Daniel P McCurdy, CEO, Allied Security Trust and chairman, PatentFreedom

Royalty Pharma has been attracting increasing levels of institutional investment, as Herman goes on to explain: "People invest in us at a net asset value which includes all the royalty streams we've invested in so far and there's no question that institutional investors have become much more interested in us as an alternative asset class." While declining to disclose the level of return that investors in Royalty Pharma's fund can expect to receive, he says: "We're investing in intangible assets that are single product-based. This makes these assets riskier than debt instruments, so the returns are correspondingly higher."

Currently invested in around 24 royalty streams, Royalty Pharma has built up a broad-based network spanning researchers, academic institutions and biopharmaceutical companies. This means that it offers investors a diversified portfolio. And, relatively long-established, it is able to tap into low-cost capital – a real barrier to entry, Herman believes, for other companies that may be enviously eyeing his business model.

Looking ahead

But while the general mood may be upbeat, not everyone is optimistic about the arrival of a brave new world for IP. Dan McCurdy, chairman of PatentFreedom LLC, cautions that there is no immediate prospect of a silver lining to the financial and economic storm clouds: "No one will escape from this crisis. And there's no reason why intellectual assets should escape either. It's not so much the financial crisis, but the fall-out from it that will be serious. The global recession will be profound and demand for products and capital-spending projects will decline. So money for enforcement, innovation and licensing will all be in shorter supply."

And McCurdy is not the only one. "The danger facing all of us in this industry is that the regulators will now try to enforce too much rigidity onto the marketplace. It's conceivable that they will attempt to nail down asset classes more tightly – rather than focus as they should on the transparency and complexity of the asset," says Ken Jarboe of the Athena Alliance, a non-profit organisation dedicated to public education and research on the emerging global information economy. "If that happens, pension funds and other major institutional investors could be prevented from investing in anything other than tightly defined 'dirt' assets. If there's a flight to that level of safety, then we're all in trouble." This means, he continues, that the IP industry needs to be on its guard. "Right now, everyone is in fire-drill and blaming mode. And when you're putting out the fire, you're not talking about where to install new sprinklers and smoke detectors," Jarboe

The patent market in a troubled time

We expect the supply of patents for sale to increase during the recession, the demand to shift as product companies constrain their budgets and non-practising entities (NPEs) increase their purchasing, and the risk of NPE assertions to increase. Product companies will need to seek new defensive patent strategies to augment their traditional strategies to restrain NPE assertion costs.

Three factors will drive increased patent supply (sellers): first, increased issuance of patents; second, increased sales of patents from companies seeking to reduce their overhead or increase their cash, or from distressed company sales; and third, the growing appeal of improved liquidity for inventors from public auctions such as Ocean Tomo.

IP demand (buyers) will shift as the 2009 recession affects corporate budgets. Product companies will decrease their budgets for IP purchase or extend their review processes, thus reducing purchases. NPEs will increase their buying in the market. Overall demand may remain constant, but NPE purchasing will increase in 2009.

Litigation history indicates clear increases of patent litigation against technology companies in and following recessions, especially for non-US firms. After the tech crash in 2000, patent litigation against large technology businesses increased dramatically. We expect a similar trend to develop in 2009, with more quality portfolios in the market, new NPEs being formed and offensive patent assertions increasing.

Additionally, NPE litigation statistics for 2006 through September 2008 show an increase in NPE-based litigation in the US from 10% in 2006 to 16% in 2008. This trend should accelerate in 2009.

Product companies can expect increased NPE risk and costs in the 2009 recession. Current defensive strategies will not keep up with the increased supply and demand shift in the IP market. They should invest in new defensive strategies. Joining a defensive patent aggregator allows IP management to reduce their NPE risks and costs, at lower net cash outlay and with less staff time. In a recession it will be a key new tactic for cost reduction and risk management.

David Ruder, VP business development, RPX Corporation

Moves to put patents on the balance sheet

The current financial market crisis affects four different fields of the IP community and the evolving IP business: the financial market for IP; financial service providers; companies; and the market for IP.

The market for securitisation such as CDS, ABS or other commercial papers is pretty dead at the moment, as is the market for IP-based papers. But there is also a good side to this. Financial institutions are now trying to gain a comprehensive understanding of the risks involved. Instead of ignoring risks, they have started an intensive analysis of the asset IP. This will prevent careless or useless investments in IP and should help to avoid an IP investment bubble. The requirements for evaluation and risk analysis have increased considerably. This is a good opportunity for high-quality services and badly needed standards for transparent evaluation.

In the months to come even companies with good ratings will have difficulties in obtaining outside capital financing, above all medium-sized companies. Even companies big enough to turn directly to the capital market for funding will have difficulties in satisfying their funding requirements. This is a good opportunity for IP-based financing solutions, which had previously been more expensive as a rule when compared to similar concepts for tangible assets due to the extensive analysis necessary. Debt-based solutions and sale and lease (license)-back concepts will gain momentum.

In Germany, a far-reaching revision of the Commercial Code is under consideration. It is expected that in the future there will be a requirement to include patents in the balance sheet. This requirement to capitalise will provide a more transparent picture of a company's situation for investors and capital providers. This is a positive signal for capital market communication in times where there is a demand for capital, but a high risk aversion on behalf of investors. At the same time, the new requirements will increase the pressure on companies to capitalise those assets. Improved evaluation principles, transparent risk analysis and funding requirements will increase utilisation of IP-based financing.

We will very likely see a growing number of companies failing and falling into insolvency despite having good technologies and good IP. Therefore, more IP will be available following insolvencies. Due to the pressure for capitalisation, the market for IP will increase as companies have to use all their assets to generate liquidity. This will eventually intensify the activities of patent trolls, offering investment opportunities for those with capital who are currently avoiding the equity markets.

Professor Alexander J Wurzer, director of the Institute for Intellectual Property Management, Steinbeis-University, Berlin

says. "Starting soon and continuing over the next six to 12 months, however, the regulators are going to be looking at long-term prevention measures for the years ahead. This will be a key time for professionals in this industry to start getting actively involved in the policy debate that is set to develop."

Although unwilling to speculate too much in the midst of such volatile times, most of the IP professionals interviewed for this article believe that the long-awaited IP boom will have been given a helping hand by this financial crisis. But don't expect any hugely dramatic developments – the brave new era will take time to arrive. "I believe that it will take another five years for us to have a market for the effective transfer of IP value in Europe," says Wurzer. "We need to see value coming from the expectations of IP buyers – that's what's really needed to drive the market. Until now, IP markets have been very idiosyncratic. From now on, we need to see plenty of standardisation and liquidity. We still need more time and more confidence."

There is no doubt that times are tough and all types of IP professional have to work a lot smarter. But despite the warnings from McCurdy and Jarboe, there do appear to be opportunities. If the downturn does translate into an upsurge in patent sales, this could spin out a number of benefits: market liquidity would increase, valuation methodologies would come under the spotlight and a standardised valuation process might emerge. For their part, institutional investors – disenchanted with pre-crisis investment vehicles – may begin to target very significant allocations to intangible assets, provided they can be shown to be based on high-quality IP. And financial institutions might reassess IP as a valuable financing tool.

Summing up, it looks like there could be plenty of opportunities over the next couple of years. Then it will come down to people having the courage of their convictions and being prepared to invest when times are tough. Those that do make the right decisions will emerge very strong when the green shoots of recovery start to appear. We could be about to enter a defining period in the development of the IP marketplace. *iam*

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