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From IP to IPO

The growing investor interest in the IP asset class presents an attractive opportunity for private IP companies

Over the past 18 months, we have witnessed a sharp increase in activity and demand in the public markets for IP companies. In aggregate, over US$1 billion has been raised by IP companies in the capital markets since 2011. With RPX Corporation (NASDAQ:RPXC), we saw the first initial public offering of a pure-play IP company, underwritten by Goldman Sachs and Barclays. With Vringo (AMEX:VRNG) and Document Security Systems (AMEX:DSS), we watched private IP companies 'go public' through reverse mergers. These events, among others, reflect a growing interest from retail and institutional public market investors in participating in an asset class that can yield very attractive, uncorrelated returns.

Of course, the public market can be a challenging place for IP companies. There is an inherent conflict between investors' desire for quarterly growth and visibility, and the lumpy and unpredictable nature of cash flows. The confidential requirements of the business limit disclosure and investor communications. IP assets are complex to analyse and price, and management teams often struggle to articulate their value to the investment community. As well, volatility in the sector remains high. Yet over the long term, investors have realised significant returns. For instance, Acacia (NASDAQ:ACTG), VirnetX (AMEX:VHC) and Wi-Lan (TSE:WIN) have seen their share price multiply by factors of between two and 10 over the last three years. Moreover, early-stage biotechnology and junior mining companies share similar challenges and yet many have found success in the capital markets. So IP companies can and do thrive in the public markets. But why should a private IP company consider going public?

A private IP company can realise substantial benefits by going public. First, the public markets offer premium valuations relative to the private markets, driven partly by greater liquidity and the scarcity value of public IP companies. Aside from benefiting shareholders, a healthy premium valuation can allow management teams to leverage the relatively lower cost of capital to accelerate the growth of the business. Consider the example of Vringo. Just a few weeks before its merger with private IP company Innovate/Protect in March 2012, Vringo's shares traded in the US$1 range. In the months following the merger, the stock topped US$4. On 9th August Vringo raised US$31.2 million at a price of US$3.25 per share, using the proceeds to acquire a portfolio of over 500 patents and patent applications from Nokia. As the stock peaked at over US$5 in October, Vringo raised an additional US$45 million, and proceeded to acquire additional patents in early November. Vringo's management team leveraged the company's access to low-cost capital to diversify its IP portfolio and create a more sustainable, long-term platform. Acacia has successfully employed this strategy as well. In February, following its US$160 million acquisition of Adaptix and seeing its shares near an all-time high above US$40, the company raised US$225 million to pursue additional acquisition opportunities.

Public IP companies with access to more capital at a lower cost can compete more effectively for high-quality IP assets. Robust intake capabilities – identifying and acquiring assets – should translate into higher valuation and less volatility as investors favour companies that are diversified and have the proven ability to 'reload'. The result is a virtuous cycle, in which healthy valuation and access to low-cost capital increase the intake of valuable assets, which in turn reduces volatility and lifts valuation.

On 6th November, VirnetX was awarded US$368 million in its patent lawsuit against Apple. Over the next two days, VirnetX's market cap soared by half a billion dollars. Like Vringo and Acacia, VirnetX has a valuable opportunity to raise tens or even hundreds of millions of dollars – at a healthy valuation – to acquire additional intellectual property. Such opportunities are almost non-existent for private IP companies.

Second, the public markets offer the opportunity to implement long-term equity compensation plans for employees that align interests and allow companies to attract, retain and motivate talent. Top talent is a key driver of success in any sector, but arguably more so in intellectual property, where the same asset can yield divergent outcomes under different management teams and the pool of seasoned professionals is not very deep.

Further, fast-growing small-cap public IP companies can compete effectively with leading technology companies for IP talent, as the potential upside in their share price is often perceived to be greater than that of large-cap Fortune 500 companies with market caps already in the tens or hundreds of billions. Driving home this point are recent hires by RPX, Acacia and Vringo, which have come from top-notch IP organisations at Microsoft, Cisco, Texas Instruments, Broadcom and Nokia.

Third, the public markets may offer US-based owners of private IP companies an opportunity to benefit from more advantageous tax treatment. Consider the owner of a private IP company generating licensing revenue (ordinary income) who converts his or her ownership stake into public company stock (long-term capital gains).

Finally, the heightened credibility and exposure that come with a public listing can be tremendous assets in business development, recruitment and partnerships. Coupled with a balance sheet and top-notch talent, public IP companies have an opportunity to create a quality brand in a sparsely populated industry.

Ultimately, management teams of private IP companies ought to weigh the pros and cons of going public with regard to their strategy and business goals. With increased investor appetite in the asset class, IP companies that demonstrate significant upside potential could expect not only a warm reception in the public markets, but also a platform to accelerate growth and improve their market position.

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