

Rising prices and changing strategies

The patent brokerage business has experienced a lift-off over the last five years, driven mainly by the activities of Intellectual Ventures. But although many more deals are now being done, its future still lies largely in the hands of this bold and mysterious operation

By **Lew Zaretski**

"Prediction is very difficult, especially if it's about the future," wrote the physicist and Nobel laureate Niels Bohr. And not even a decade ago, it is doubtful that many people would have predicted the situation we find ourselves in today. The last several years have witnessed changes that have dramatically elevated the importance of, and excitement surrounding, the patent brokerage business. These include the landmark US\$173 million RIM GSM/UMTS patent purchase recently announced by Dow Jones.

Fundamentally, there seems to be four trends at work:

- Patent transaction data compiled over the past six years shows rising prices, as well as increasing liquidity and transparency in the marketplace.
- Observation of major buyers and sellers shows a host of new business practices on both the buy-side and sell-side.
- Massive deal flow for large buyers threatens to cause a flight to quality in the future.
- The bold and mysterious Intellectual Ventures drives market demand, leaving all market participants dependent upon its future direction.

The way life used to be

As recently as 2002, patent brokerage transactions were few and far between. Patent brokerage was not on the minds of senior executives or IP decision makers, the former generally relegating IP matters to the legal department and the latter generally focusing on portfolio development and

patent litigation. In 2002, we observed just three significant public patent brokerage transactions (outlined in Table 1).

It is quite likely that a number of additional transactions occurred on a private basis. Aside from the deals highlighted in Table 1, a few prescient buyers were visibly seeking to acquire small sets of patents from start-ups destroyed by the bubble-induced recession. Looking back, Broadcom, Unova, Microsoft and the others were patent brokerage pioneers in a sense. They took a new approach to create value despite the obvious risks associated with operating in a nascent market.

In those days, few parties viewed patent brokerage as a useful option, for several reasons. A lack of visibility into supply, demand and price levels raised transaction costs, and made some transactions economically unfeasible. There was also a distinct lack of decision-maker motivation and comfort in transacting patents. Executives would wonder: "What if we need these patents?"; "What if we buy the wrong patents?"; and, worst of all, "Will I get fired for this?" Furthermore, many decision makers remained anchored on patent licensing as the only value creation option and saw standard legal defences (eg, invalidity and non-infringement studies) as the only option for protecting their firms from patent licensing aggressors.

Fortunately, changes would come and begin to sweep away these obstacles.

The new age of patent brokerage

Events over the following years eliminated each of these obstacles. The drumbeat of major litigation damages and significant settlements simultaneously fuelled

excitement about the potential value of patent enforcement.

At the same time, Nathan Myhrvold and Intellectual Ventures (IV) became eloquent advocates for the value creation opportunities available through patent brokerage. As IV reached out to IP owners around the world offering to acquire patents, owners discovered that sale was a concrete option available to them. For many, liquidity had arrived, and with it came motivation and a parting with tradition. Nowadays, it is rare to meet an IP owner that has not received an inquiry from IV. Even when an owner does not sell to IV, the experience educates them and as a result they sometimes enter the market later. Thus, IV's demand has also increased the supply of patents to the entire market.

This dynamic resulted in increasing numbers of high-profile sales. In 2004, there was the remarkably successful CommerceOne bankruptcy auction which yielded US\$15.5 million. While the transaction itself was not unprecedented in its size or nature, the spectacle of the live public event and the massive media buzz around it created excitement throughout the market. This event alerted all of the value creation possibilities available through patent brokerage. Subsequently, Ocean Tomo introduced its public patent auctions (see Figures 1 and 2) in 2006, boosting transparency for all.

Deal flow and price levels in the new age

In an attempt to get a better understanding of the marketplace, ideally one should continuously monitor and study both individual transactions and aggregate transaction levels. This is because individual transactions and aggregate levels are extremely useful in understanding supply and demand levels, and therefore pricing future transactions. Without such study, market participants are operating in the dark and likely to sub-optimize their decisions. Table 3 provides data from the ThinkFire patent brokerage transaction database, illustrating deal flow and price levels.

Readers will recognize two key points. First, the database contains a significant quantity of deals and should provide a reasonable perspective on the marketplace. Unfortunately, however, the database does not contain a remotely complete view. This is because our market is opaque. It is said that IV's transactions in 2007 alone would exceed the combined value of deals monitored in the six-year period covered in Table 3, and that the total patents IV has acquired over the

Table 1. Key patent brokerage transactions 2002

Buyer	Seller	Quantity of patent families transacted (US issued)	Amount (\$US)
Broadcom	Unova	90	\$24m
Microsoft	Liquid Audio	23	\$7m
Veritas	Storage Engine	6	\$1m

Table 2. Selected major high-tech patent litigation damage awards and settlements, 2002-2004

Year	Plaintiff	Defendant	Amount (\$US)
2004	Eolas	Microsoft Corporation	\$565m
2004	Sun Microsystems, Inc	Microsoft Corporation	\$900m
2004	Intertrust Technologies Corporation	Microsoft Corporation	\$440m
2004	Yahoo, Inc	Google, Inc	\$328m
2002	Intergraph	Intel	\$300m

period would be several times the quantity the table observes. The data basically provides a periscope view of the marketplace and there is a lot that it does not record. Still, this view is a substantial improvement over many of the alternatives.

Deal watch

Looking at the individual deal data, it is possible to begin to understand the range of deals occurring in the marketplace. As illustrated in Table 4, the average deal transacts at US\$2.74 million and contains 11 US issued patent families.

As the quantity of assets in prospective deals varies widely, it is useful to break the figures from Table 4 down to a per-asset basis to enable easy comparison of all deals (see Table 5).

Figure 1. Ocean Tomo public auctions – gross proceeds

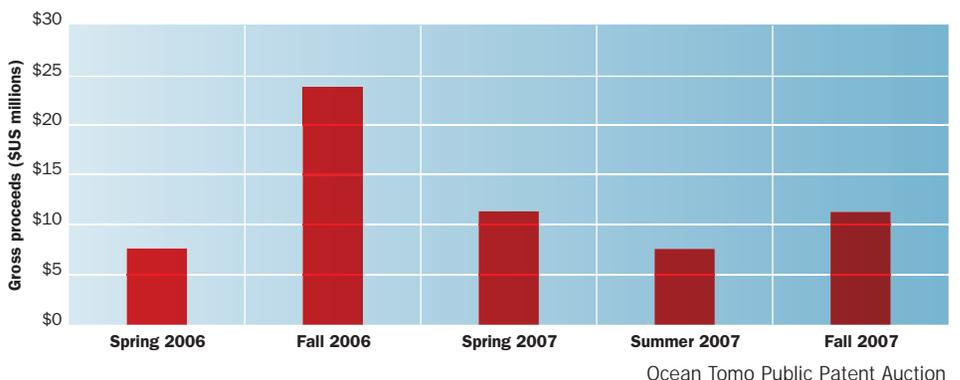


Figure 2. Ocean Tomo public auctions – lots transacted

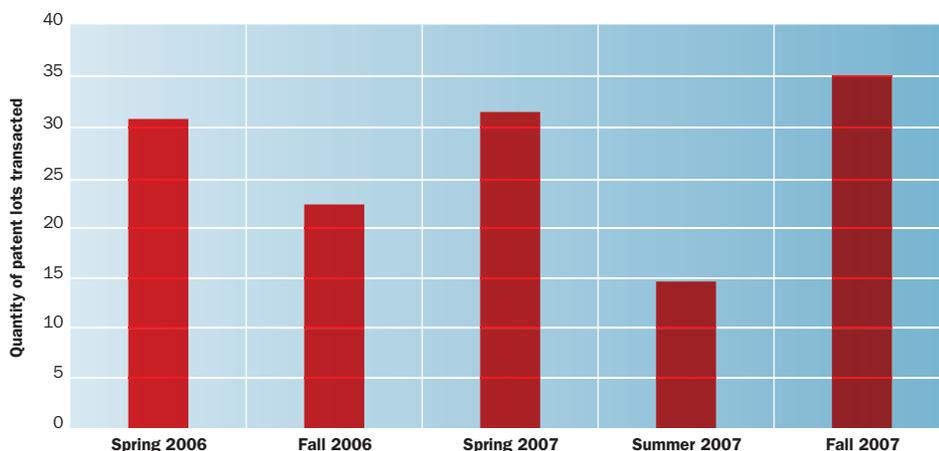


Table 3. ThinkFire patent brokerage transaction database summary

Overall summary statistics	Value
Years covered	2002-2008
Quantity of deals	163
Total gross deal proceeds transacted	US\$447.35m
Total US issued patent families transacted	1,083
Average sale price/ issued US patent family	US\$413,000
Median sale price/ issued US patent family	US\$110,000

Focusing on the median values is most useful because the database contains several massive outlier transactions which cause the average and the median to depart substantially. These outliers include the RIM deal, the US\$70 million MOSAID-Agere deal and several others. Finally, Table 5 breaks down the distribution of results to depict the range of possible outcomes.

Of course, the unique characteristics of a specific patent lot and the market conditions at the time of the transaction drive the sale price. It is well worth comparing any deal against previous transactions, both overall and *vis-à-vis* those most comparable to that proposed.

While 2008 is young, there have been a couple of deals and it is possible to plot a preliminary trend chart indicating price level changes over the past three years (see Figure 3, page 64).

Beyond the numbers – key business trends
Several key trends can be observed in

today's market – these can be divided into those affecting the buy-side and the sell-side.

Buy-side

On the buy-side, there have been two fundamental transformations. First, and most obviously, the proliferation of non-practising entities (NPEs) – such as IV, Acacia, Rembrandt IP Management and Altitude Capital, which all seek patent acquisitions to fuel their growth – has substantially boosted demand and, accordingly, price levels. In fact, IV's vast funds and voracious appetite for patent acquisitions makes it by far the largest acquirer of patents worldwide by a very substantial margin and probably gives it significant pricing power. It is quite possible that IV represents well beyond 50% of aggregate market demand.

Secondly, and perhaps less obviously, a tremendous transformation has occurred in many companies. This has moved them from either market agnostics or opportunistic window-shoppers to fully committed strategic patent buyers. As *IAM* readers know, senior management and board-level executives increasingly recognise the strategic importance of IP, in terms of both risk and opportunity. For example, a 2006 Credit Suisse economic study estimated that Nokia enjoyed a 5% to 10% margin advantage over its largest competitors due to the superiority of its IP position and its ability to leverage that position accordingly.

With the increased strategic importance of IP, senior management is increasingly committed to investing in IP acquisitions to achieve specific objectives, such as reducing royalty costs. RIM's US\$173 million acquisition of 55 families of GSM/UMTS patents is likely to have been such an acquisition. Prior to it taking place, RIM held just 12 patents declared essential to the ETSI 2G GSM/GPRS standards, compared with 43 for Motorola, 132 for Ericsson and 303 for Nokia. Clearly, RIM is making a massive investment in this IP and it expects a strategic payoff that ensures its access to markets, reduces its royalty costs, increases its margins and perhaps even blocks or taxes its IP-weak competitors to the advantage of its own business.

As a consequence of the above, many companies have developed significant, dedicated patent acquisition capabilities. These include acquisition strategies targeting specific technology areas, dedicated acquisition headcount – including the increasingly popular retention of a

Table 4. ThinkFire database – summary statistics (individual deal)

Individual deal summary statistics	Max	Average	Median	Min
By gross deal proceeds	US\$173m	US\$2.74m	US\$170k	US\$2,200
By US issued patent families transacted	206	11.28	2	1

Table 5. ThinkFire database – summary statistics (per asset)

Individual deal summary statistics	Max	Average	Median
Gross proceeds per asset	US\$12m	US\$413k	US\$110k

director of IP acquisitions – and refined processes for generating and managing deal flow, vetting opportunities and executing deals. Lastly, such companies commit significant annual budgets for acquisitions.

This transformation, in combination with the arrival of the NPEs, drives market demand considerably higher.

Sell-side

Change on the sell-side is in some sense parallel to that on the buy-side. Again, the evangelism and outreach by IV and other NPEs have helped many IP owners become savvier about patent brokering opportunities.

In addition, some large IP owners are transforming formerly opportunistic patent divestitures into real businesses. These IP owners typically generate large quantities of new patents each year and, as a consequence, discover that there are ample opportunities to divest patents on a regular basis while maintaining large, strong portfolios sufficient to support their businesses.

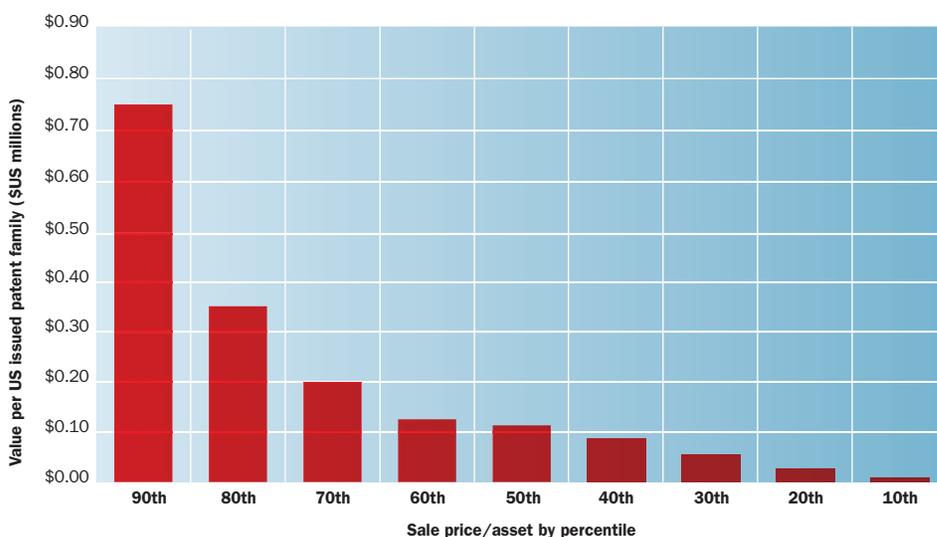
As an ongoing concern, an IP divestiture business can leverage multiples to create value for its parent company well beyond the simple revenues and earnings it creates. Again, management must operate these businesses on an ongoing basis, as divestitures viewed as one-time events will not justify a multiple. Table 6 illustrates a simplified case for enterprise value creation through operation of an IP divestiture business.

With the creation of these IP divestiture businesses, companies develop dedicated patent divestiture capabilities. These include retention of dedicated staff and development of processes for generating and managing deal flow, marketing opportunities, managing channels to market and executing deals.

Developing a pipeline of assets for divestiture is among the most challenging aspects of building an IP divestiture business. This requires a business model aligned with the company's corporate and IP strategies to facilitate approval of each patent lot by the stakeholders responsible for the assets. Historically, the most common model has been the opportunistic model, simply involving the occasional sale of assets related to a divested business. Unfortunately, this model is not usually suited to an ongoing divestiture business. Newer models use various methods that focus on providing a continuous pipeline of deals.

One such model is the patent licensing alternative. Companies are increasingly considering divestiture of extremely strong

Figure 3. ThinkFire database – sale price distribution (per asset)



patents which would otherwise constitute the basis for strong licensing programmes. If the IP owner prefers to avoid conflict with the likely licensees, prefers to avoid protracted licensing negotiations or litigation, or prefers a short-term payoff with lower risk, this can make sense. The RIM and MOSAID-Agere deals cited earlier are prime examples of the high-value returns possible through this model.

The marketable over-coverage model produces high-value lots for divestiture by selling off excess patents in portfolio areas of extraordinary strength. For example, a leading server vendor such as IBM has far more quality server patents than required to protect it and to fuel its licensing programmes. The model involves prudently divesting a share of these patents to create high-value lots.

Finally, the marketable non-core model works well for large technology companies that routinely exit businesses or change direction, leaving behind patents that are no longer required. This model produces a strong pipeline of patent lots for sale but requires careful management to ensure that only saleable lots go to market.

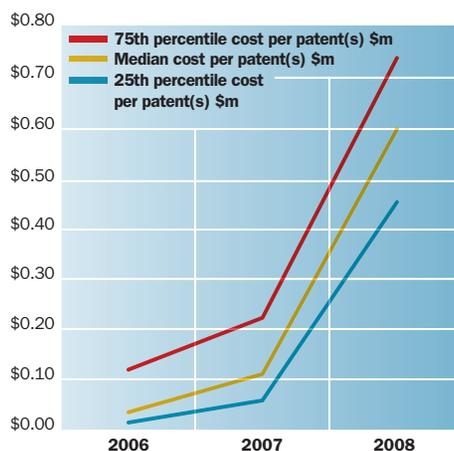
This transformation from the sell-side, in combination with the IV's evangelism, drives market supply considerably higher.

The future

With the wise words of Niels Bohr in mind, it is time to move to the realm of speculation as to what the future will hold.

The aforementioned increase in supply and demand promises to fuel increased

Figure 4. Patent brokerage sale price/asset 2006-2008



liquidity. To the extent that liquidity comes through public transactions, transparency will also increase. Increased transparency should reduce economic transaction costs, favouring more frequent transactions and more activity in the marketplace.

Increased transparency is beneficial to many market participants as it helps all to assess more confidently the value of transactions. Market participants should pursue a variety of initiatives to increase transparency. Commercial offerings should grow to include data services such as those provided by firms such as Datastream in various financial markets, as well as rating services such as those offered by Dun & Bradstreet or Moody's in credit markets. Furthermore, cooperative industry initiatives, such as those led by Gathering 2.0, may further serve to enhance transparency.

Unfortunately, increased market activity may have a downside, as buyers become inundated with an unmanageable barrage of deals. Some large buyers already see several hundred deals each year.

Something else to look out for is a flight to quality, for some buyer types at least. As buyers achieve high levels of deal flow and know that more offerings are imminent, they will set an increasingly high bar for deals they are willing to consider or execute. It may thus become more difficult for sellers to get serious consideration, despite buyers having increased acquisition capabilities. Patent lots of extremely high quality in hot areas, such as RIM's newly acquired GSM/UMTS patents, may fetch stratospheric values, while increasingly other lots may not transact at all or may go only to buyers with value investing styles that capture very low prices.

Finally, IV's dominant buy-side position makes the entire market extremely reliant upon the direction of this bold and

mysterious venture. While those who have enjoyed the development of the market may hope for IV's continued or even accelerated acquisition of patent portfolios, other possibilities exist:

- IV could follow the trajectory of large technology operating companies, determining that its portfolio is sufficiently large so that in future it need only focus on acquiring the highest-quality patents.
- IV could shift increasingly towards emphasising internal development of patents, a business in which it is already deeply involved.
- IV could begin selling patents on a significant scale, perhaps while continuing to acquire new patents to reorientate its portfolio.

Whatever the case, IV's direction has great importance to all involved in the patent brokerage market. Its massive demand position means that a shift in its behaviour will affect everyone. ■

Table 6. Hypothetical IP divestiture business value creation (simplified)

Assumption	Value	Comments
Price/lot divested (\$m)	US\$5 million	Assumes each lot ~ 45 families
Lots divested/year	2	Recurring over several consecutive periods
IP divestiture revenues	US\$10 million	
IP divestiture margin	75%	Conservative, US\$2.5 million SG&A
IP divestiture earnings	US\$7.50 million	
P/E ratio	20.00	Typical large high-tech
company P/E ratio		
Value created	US\$150 million	

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