

China's emerging patent trading market

Although the Chinese patent transactions market is currently small and relatively unsophisticated, over the coming years that is likely to change

By Chris Bailey

The IP community's dinner table conversations about China inevitably revolve around several recurring themes. One is the tremendous growth of China's indigenous patenting activity. The statistics are so often cited that I risk tedium by mentioning that in 2010 the State Intellectual Property Office (SIPO) received over one million applications – an increase of 28% on the previous year.

This is attributed in part to the National IP Rights Strategy, a bold multi-agency plan which aims to turn China into a knowledge economy by 2020. The strategy is a matrix of different policies and initiatives, boosting research and development (R&D) spending in key sectors, promoting local procurement and providing subsidies for prosecuting domestic or international patents. China aims to leapfrog decades of technological development, take a global lead in certain strategic industries and bypass the burden of royalties on foreign-held patents. A 2009 Thomson Reuters report shows how rapidly China's domestic and foreign patent applications have grown, with 12,337 Patent Cooperation Treaty applications in 2010 – a growth of 56%. This storyline is that China will rapidly become an IP superpower.

The dissenters to this view note that patent quantity and quality are very different things, and even the SIPO has admitted that a large number of domestic patents are junk.

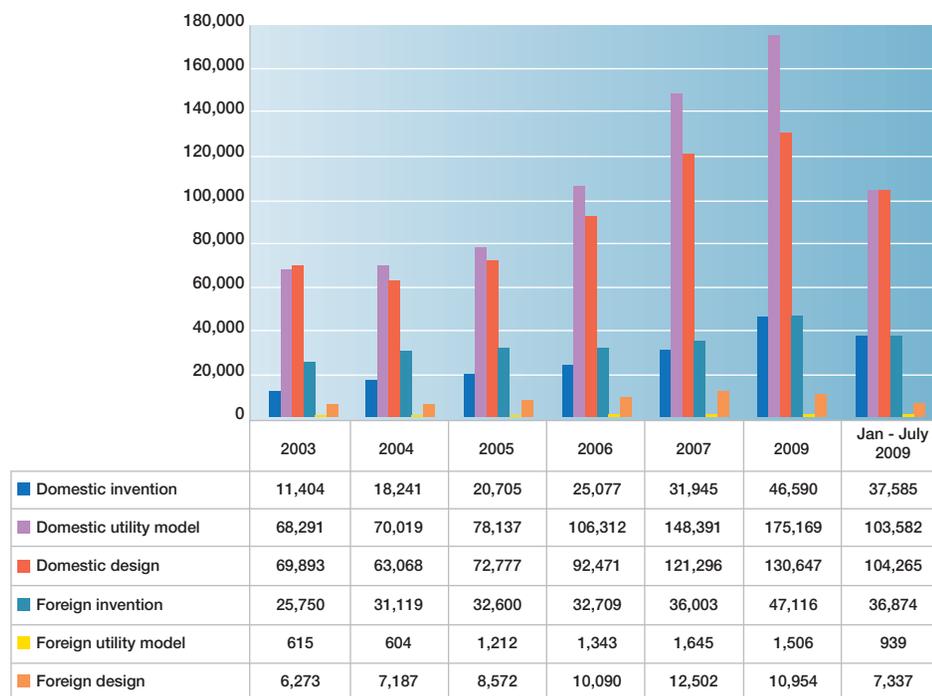
Most of those patent statistics comprise non-examined design and utility model patents, and it is yet to be seen how many Chinese applications overseas are actually granted. The doubters also point to relatively weak IP enforcement in China itself, with lack of injunctive relief and low damages awards depressing the value of patents there. And as many in the technology community point out, R&D capabilities cannot be built overnight, however deep your pockets.

A pipeline of inventions relies on strong commercial and human management, and many of the most productive research partnerships in the corporate and academic worlds have taken years to develop. The bulk of China's R&D spending is directed to state research institutions, which also comprise a bigger proportion of patentees than the United States, Europe or Japan, suggesting a lesser role for the private sector. This story is that despite the huge investment, domestic R&D is unlikely to bring China IP superpower status in just a few years.

As I once saw brilliantly presented by Mark Blaxill of 3LP Advisors, China's IP deficit, especially among private sector exporters, means a "vicious IP spiral", with low revenues starving the technology development cycle and exclusion from lucrative markets. In the United States, Chinese companies are increasingly defendants in Section 337 complaints, with 19 complaints in 2010 alone naming Chinese defendants, compared with eight in 2009.

A third storyline, however, is that the Chinese government and its corporations are well aware that the technology gap cannot be bridged with a patent Great Leap Forward, and will look to buy technologies. Indeed, outbound acquisitions of technology companies by Chinese buyers are on the rise. The largest in 2010, Geely's

Patents granted in China



acquisition of Volvo, was a prominent example, with Volvo's brand and technology as the clear rationale for the deal.

Within this context, you might think it logical that China should also be an eager market for intermediaries to assist companies in brokering technologies – whether to gain a stake in key standards, to acquire a strategic new technology or simply to have some defensive assets with which to retaliate against litigation threats. However, China's patent transaction market is still in its infancy. I have spoken to some of the leading players – Jon Rortveit of Tynax, Mike McLean of UBM Techinsights, Raymond Zenkich of Red Chalk Group – as well as our strategic partners Patrick Snow of Iceberg Transactions and China's Technology Exchange (CTEX), to garner their insights. What I found is a market which is barely coming to life, but which holds tremendous potential.

The litigation imperative

As Ashby Monk has noted in "The emerging market for intellectual property: drivers, restrainers, and implications" (*Journal of Economic Geography* 9 (2009)), the patent transaction market in the United States is largely driven by litigation. Patents are traded not so much for the value of ownership as for the cost of not owning

them when there is litigation at stake. For Chinese companies, however, this is rarely a driving factor. In the US market, with a few notable exceptions, Chinese companies tend to be defendants, and most often in Section 337 actions. Having been involved in contacting some of these defendants to assess their needs, I typically found that they are small or medium-sized exporters or manufacturers which have nothing like the means to engage in costly litigation in the US for the sake of what is often a small quantum of sales. Most of them therefore simply stay out of the US altogether. Even very large Chinese corporations find the costs of litigation overseas an unattractive gamble. For Chinese companies, US patents are rarely litigation assets.

As for the domestic market, China's patent litigation landscape offers far less to the patentee. Preliminary injunctions are rare, costs and damages are low – the average damages award for patent infringement in the past four years in China was only RMB163,664 (approximately US\$25,000). The volume of junk patents, subsidies for patent prosecution and low lawyers' fees mean that there is plenty of scope for nuisance litigation, but relatively few big-stakes cases. To quote one IP counsel, in China: "There are no patent trolls, only patent cockroaches."

In this context, with patents as commodities, it is unsurprising that they have a low value as weapons in litigation. As an acquaintance in a local law firm in Guangzhou recently joked, the Chinese still say that being an infringer and having to make a settlement payment if you lose is a better return on investment than being the innovator. Previous statements from senior government and judicial figures imply that while damages award are increasing, China does not want to grant patentees the same powerful remedies available in the US, meaning that non-practising entity business models may not be viable in China, at least in the near future.

Perception barriers

While most of the transaction experts I spoke to claimed successes, a few isolated transactions do not make a market. I have found few companies in China that are aware of the potential for transacting patents, let alone that have some understanding of the mechanics of sourcing buyers or sellers. The vice president of a Chinese technology firm listed on NASDAQ whom I once approached admitted that he had never even heard of the concept of patent trading.

Another perception barrier is that with the drive for indigenous innovation and the large volume of patents being filed, many companies believe that in-house R&D is already sufficient for their strategic direction, at least for the domestic market.

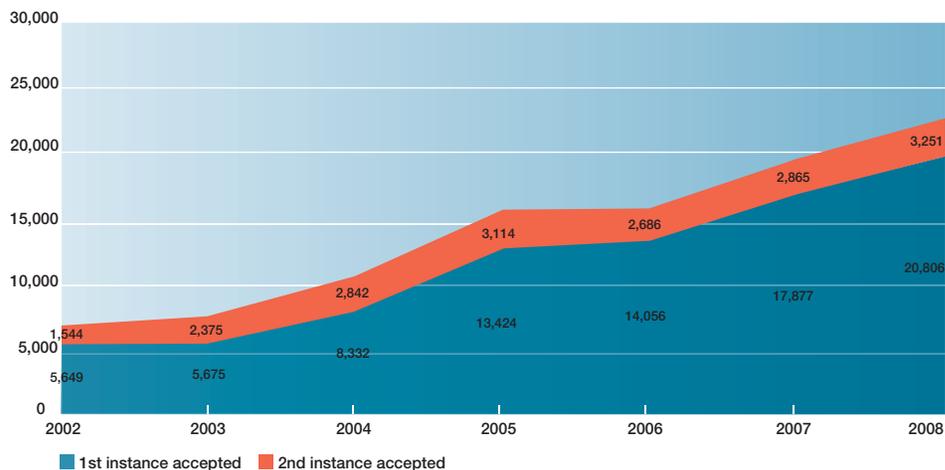
While Rortveit has noticed a “dramatic mentality change” when it comes to management of Chinese companies in recent years, but estimates there are still three to four years for the market to develop. Interestingly, according to Zeng Yun of the China Technology Exchange (CTEX), the only brokers currently active in China are all foreign and China has not yet seen any local specialists – although some patent firms will engage in opportunistic licensing or disposal for their clients on an *ad hoc* basis. This is a good indicator that the market is still emerging.

Technology capabilities

Another set of problems comes with the types of portfolios that are offered from the sell-side market. Chinese companies have little appetite for patents covering emerging technologies that require further time, money and expertise to put into practice. For example, two prospective buyers of a new fuel cell technology which seemed to be ideal targets turned down an offer we made because they did not have the requisite R&D capability to develop the technology, even with technical support from the inventors offered as a condition of the sale. Many Chinese companies either lack their own R&D expertise to make use of early-stage technologies or cannot contemplate further time, expense and uncertainty to bring them to market. They want patents which they can monetise immediately.

This may explain why technology acquisitions by Chinese companies are happening more often in the guise of corporate acquisitions. A brief look at a report by Deloitte of outbound acquisitions by Chinese companies reveals that apart from natural resources, energy and financial sector acquisitions, at least 17% were in the technology, media and telecommunications and automotive sectors, and many of these deals were announced explicitly as technology acquisitions. The Chinese acquirer is gaining the whole package of market-ready technologies, know-how, R&D resources and talent, not only the raw patent assets. While acquisition of a patent portfolio would clearly be simpler and much less expensive than acquiring a whole company, I believe that for many Chinese corporations, buying companies is the most effective form of investment in technology acquisition.

China IP civil actions



Value judgements

By far the most common frustration that all the experts I spoke to cited in dealing with potential Chinese buyers was a mismatch in valuation. Patent valuation is not, of course, a straightforward process in any market. This is something that Harvard’s Frederic M Scherer has acknowledged: “Obviously one thing a market does is determine prices. With patents or patent licenses this is reasonably tricky. Patent licenses are options on an uncertain future.” However, in the United States and Europe, there are recognised benchmarks which form the starting point for negotiations.

When an IP transaction specialist in the US sees a flow of potential deals, he or she becomes adept at making a rough assessment of the potential price, subject to further due diligence. For a Chinese company confronted for the first time with a patent family with an asking price of US\$250,000, they may have no comparables to make any assessment. As Zeng has estimated, the typical price for a Chinese domestic patent is RMB40,000 (approximately US\$6,000), so it is hardly surprising that prices for foreign portfolios may seem astronomical. All the experts I spoke to agreed that there are often huge disparities in valuations between Chinese and foreign parties. Zenkich said however that some Chinese clients that his firm regularly approached were beginning to realize that the high asking prices for highly attractive portfolios, such as those related to essential aspects of telecom standards, approximated actual transaction values, and in many cases can soon exceed the original asking price. And despite the impression that China is awash with capital, Rortveit

also cited a lack of access to capital as a frequent problem, particularly for private companies that do not have the same strategic clout as state-owned giants.

Making the first move

A related issue is the ability to analyse the patents on offer and make a decision. For Chinese companies with domestic portfolios which cost relatively little to acquire and maintain, the need to manage those portfolios is less urgent and there is a relative lack of experience in assessing a portfolio's value. Further, relatively few IP or R&D managers in China can easily parse a patent in English, and most rely on translation into Chinese.

While in the US a potential buyer or its intermediary can conduct a first review in a relatively short time before deciding whether to proceed with detailed due diligence, for the Chinese buyer even a brief review may be impossible until it has spent a few thousands of dollars on a translation. This may delay it by two weeks or more, by which time a US or European potential buyer may have already started negotiations. Anyone offering patents to Chinese companies must be prepared to wait several weeks for the prospective buyer to translate and review the patents, and if the seller is specifically targeting a Chinese potential buyer it should certainly commission its own translation. Rortveit says that "it takes a Chinese company ten times longer to assess a deal". Zenkich concurs, noting that Chinese firms find it challenging to respond quickly, especially for larger portfolios where a significant amount of due diligence is required.

Zeng agrees that Chinese companies have difficulties in assessing portfolios quickly. He notes that CTEX has made more progress on deals on the rare occasions when a seller has done a lot of initial preparation on supporting information such as a prospectus and claim charts, but he acknowledges that this is not something that most sellers will undertake. Even when the potential Chinese buyer has expressed interest, there may still be many more stages before the buyer comes close to committing. Rortveit says that brokers need to spend a lot of time "handholding" to get a deal through, and that "driving a case up the pyramid is daunting".

Politics as usual

Finally, it cannot be ignored that politics plays a role in cross-border technology transactions. The most high-profile recent example was Huawei's forced exit from its acquisition of 3 Leaf on the grounds that

this would threaten US national security. The effects that security restrictions will have on technology sales to China is as yet unknown, but as a result of the failed Huawei deal, I have seen portfolios of two other US companies withdrawn because it was feared that they may be deemed of strategic and military value, and that sale to a Chinese purchaser could be blocked. This suggests a possible role for intermediaries in third countries acting as principal buyers on behalf of Chinese acquirers.

Building for the future

Despite the obstacles facing the market, there is also universal agreement among experts that strategic logic will drive a much more active demand for patent portfolios by Chinese companies. China's National IP Rights Strategy includes in its objectives the creation of liquid markets for intellectual property; this is evident in the number of IP exchanges around the country, as well as the availability of financing through patent mortgages, currently offered by a number of commercial banks.

The leading "technology exchanges" (which focus more on technology transfer and licensing than on patent acquisitions) include the Northern Technology Exchange Market, the Shanghai Technology Transfer Exchange and CTEX. Few patents are currently offered on these exchanges for purchase or licensing and they are generally of the mechanical better mousetrap variety rather than cutting-edge technologies. However, behind the scenes, these exchanges are brokering ever-larger private deals.

Of the Chinese exchanges, CTEX is the highest profile, having been established jointly by the Beijing City government and the Ministry of Science and Technology, and can also boast the best infrastructure. Apart from a membership-based exchange which has already attracted dozens of brokers and sellers, CTEX is an exclusive agent in China for disposal of HP's patents. Visitors to CTEX's exchange hall in Beijing can see HP's patent offers listed on its display board.

CTEX held China's first patent auction in 2010, which saw 28 lots sold and generated RMB 3 million (US\$450,000); it is preparing for a second later in 2011. CTEX is also in the process of establishing its own patent fund, which will initially focus on funding international prosecution for key Chinese patents, but may later include the acquisition of foreign portfolios. CTEX already has a number of other partnerships in place, including with Iceberg Transactions, which regularly offers portfolios to the Chinese market via CTEX. Patrick Snow of Iceberg

says: "CTEX clearly have the resources and the backing, as well as the authority to approach major Chinese corporations that, as a foreign player, we may not be able to access." Iceberg is pursuing a number of projects with CTEX to deepen the existing alliance. Even so, CTEX is still small, with a handful of specialists building contacts with Chinese buyers and a network of external experts who assist the company in analysing portfolios on offer and recommending acquirers.

Other players are making inroads into the market. At UBM Techinsights, which already has a significant local presence in China, McLean told me that his company has assisted Chinese acquirers with due diligence on potential transactions. Jon Rortveit claims Tynax has already completed some "significant deals" in China, and is already in the process of setting up a dedicated Chinese exchange, in partnership with a Hong Kong and US based company (China International IP Services Ltd.), with the support of local provincial governments, associations and the Chinese Academy of Sciences that will play an active

role in training Chinese buyers and facilitating transactions by being much closer to the buyer. Rortveit admits that Tynax is very early in committing resources to China, but believes that when the market develops, it will move "very quickly".

For all the experts I spoke to, the key is to move from sell-side engagements targeting China to winning buy-side engagements for Chinese companies. To do that requires resources on the ground that can engage in patient networking, educating the market and building trust. For some in the industry, it is not too early to start. **iam**

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Action plan



While Chinese companies are clearly eager to gain access to technologies and key markets such as the United States and Europe, this need has not yet translated into an active market for foreign patent portfolios.

The main obstacles include an inability to assess quickly portfolios on offer and widely differing expectations on the value of the deal.

Patent brokers looking to the Chinese market will need to invest more in providing analysis and supporting data for portfolios on offer, and should not expect successful deals without building networks, educating Chinese companies and guiding deals through at every level.

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