

Introduction

Exciting times for IP market makers

As most of the developed world enters difficult economic times, all those who believe that intellectual property is, or could be, an asset class will have to find an answer to the following question. If the global financial system can be brought to the brink of collapse over worries about the valuation of mortgage-backed securities, what impact does that have on prospects for the development of markets based on other kinds of intangible, such as intellectual property?

Back in April 2008 – long before banks started going out of business on a daily basis and others being rescued by taxpayers – Ed Munzer, executive managing director of Paradox Capital Partners, a capital provider that specialises in IP-based loans, second-lien loans and mezzanine investments, was optimistic about the attractions of intellectual property in a downturn. Writing on the *Intellectual Asset Management* blog (www.iam-magazine.com), he stated: “Based on long experience and well-ingrained investment principles, investors will continue to invest in companies and assets associated with differentiated products that are protected by high barriers to entry from new competition, driven by the fact that these considerations indicate stronger and more reliable future cash flows and profits. It naturally follows that companies with strong IP assets and professionalised IP management, which are indicators of high levels of differentiation or of barriers to entry, will be attractive to investors, particularly as the worldwide economy becomes increasingly knowledge based. It has been documented that equity invested in companies with strong IP performs better than the average; we have little doubt at Paradox that debt invested in companies with strong IP performs better than the average.

“The current environment is one in which almost all investment houses are looking at risks in a very granular, deal-by-deal way. This is a favourable development for investments such as IP-based loans, which require a deal-by-deal approach by their very nature.

“Finally, the capital markets have been affected by structural changes in recent years. Increasingly, capital is being managed by hedge funds and private equity

groups that have great latitude in how they invest, which allows them to allocate capital where they see the best return for the risk, less bound to any particular investment class or structure. This provides support for the continued success of IP investing.”

Six months and substantial stock market falls later, does this still ring true? At the time when he was writing, Munzer was describing a market that essentially remained rational; one willing to look at opportunities as well as risks. Does that market continue to exist? Are the ‘well-ingrained investment principles’ to which he refers still applicable? This is something that we will no doubt discover over the coming years.

That said, one of the things that IP financing deals do have going for them is that they are still relatively rare. That means there is a lot of good intellectual property out there that can be taken to market; intellectual property that does stand up to real scrutiny, that has a track record of generating cash and that, even on the most conservative of valuations, can yield substantial returns.

In the end, the financial world is not going to allow itself to stand still. Too many people would lose too much if that happened. Instead, it will adapt to new conditions and, most likely, a new regulatory environment, and people will begin to go out looking for deals again. The challenge for IP owners and intermediaries will be to develop a value proposition that works in this new world.

As with all intangibles, one of the fundamental problems facing intellectual property is finding valuations that make sense to more than just a few experts. One of the reasons why the banking system came so close to complete meltdown was that too few people understood the complex deals that were being done; therefore, most of the financial world had no real idea of the value of what so many institutions actually owned. This will not be allowed to happen again – the whole concept of IP valuation needs to become much more transparent. For intellectual property to prosper as an asset class, there must be generally accepted means to undertake valuations based on principles that can be communicated in a comprehensible manner to a wide

constituency composed of board members, analysts, share owners and other kinds of investor.

There are a lot of very cash-rich institutions out there which are not interested in investing in equities at the moment, but which have money to burn. This presents the IP market with a tremendous opportunity. However, without transparent, credible and comprehensible (to non-experts) valuation, IP-based transactions will be difficult to sell to new market entrants.

At the start of 2008 there was a move to develop an international standard for patent valuation through the International Organisation for Standardisation, which is already working on a project relating to brands. These efforts are ongoing. Perhaps one of the lessons of the last six months is that valuation standards are exactly what the IP world needs. Finding them will be exceptionally tough and will require input from a wide range of stakeholders. But is there now an alternative?

Buying and selling

Although there may be some question marks over the future of IP-related financing in light of recent events, the outlook for those seeking to acquire good-quality patents and other IP rights could be very bright. That may seem counterintuitive given the present state of the global economy, but actually it is not.

Recessions are now being forecast for most of the world's major economies. The only issues are how long they will last in different countries and how deep they will be. And what happens during a recession? Companies go out of business – many more than would do during times of growth. Many of these companies will own patents and other types of intellectual property. These will be auctioned off along with other assets as administrators seek to raise cash for creditors. This is one way in which patent trolls, or non-practising entities (as they are now being called more frequently), have been building their portfolios for years.

However, non-practising entities now face rivals in these auctions. Groups such as Allied Security Trust and RPX Corporation have emerged over the last year. These groups have the express intention of allowing operating companies (ie, businesses that develop and sell products) to pool resources in order to obtain potentially valuable patents

before the non-practising entities do. The plan is that if, for example, Allied Security Trust owns these rights and grants its partner operating companies non-exclusive licences to these potentially valuable patents, non-practising entities cannot threaten these same operating companies or institute expensive and possibly highly damaging litigation action against them (or others – but there lies another story). That said, with more bankruptcies there will be more intellectual property out there in the first place. Therefore, the chances are that there will be plenty to go round – not just in the United States, but also in Europe and many other parts of the world.

However, you do not have to be a troll or a non-practising entity or a defensive acquisition outfit in order to take advantage of the current climate. Operating companies looking for new technologies can also play the game. All they need is the willingness to spend the cash. This may be easier said than done – but if you think about it, an acquisition strategy may make sense. If you can pinpoint a decent set of rights to buy, you will save a lot of time and money in research and development and will potentially save a lot of time and money in legal disputes. In difficult times, this will be very popular with both boards and investors.

But acquisition opportunities will probably not be restricted to bankruptcies. There are bound to be many solvent companies looking to raise cash in quickfire sales, especially relating to rights that they deem not to be central to their future business strategy. This may well make them more willing to listen to offers for parts of their patent portfolios, and possibly at cheaper prices than they would previously have contemplated. If they will not sell, surely now is a great time to be negotiating a licensing deal if you are a potential licensee. After all, if the alternative is a drawn-out and expensive court case, maybe a couple of percentage points off a royalty rate is a more attractive proposition for a licensor.

In short, there are going to be lots of opportunities over the next couple of years. It is all about having the courage of your convictions and being prepared to invest even though the general economy looks shaky. Those that do and that make the right decisions will emerge very strong when the recession bottoms out and things start to pick up again. And this means we could be about to enter a defining period in the development of the IP marketplace.

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