New models in response to changes in the global IP market

IP investment models are changing. This poses challenges some of which are unique to private equity and others which are shared by all in the IP acquisition and monetisation marketplace

By **Peter Holden**

As financial investors charged with squeezing the IP monetisation process into a private equity returns model, we have two goals:

- Accessing and securing the best-quality intellectual property in the marketplace at the best possible price. This requires us to be creative and flexible in terms of responding to the needs of sellers so that they are motivated to sell to us (rather than to the ever-increasing roster of other buyers), and structuring acquisition transactions in order to downside-protect our investments from the uncertainties of IP monetisation.
- Leveraging the intellectual property that we own in a cost-effective and timely way. This requires us to find new ways of crafting sales and licensing transactions based on changes in the marketplace, specific companies' defensive and offensive needs and a deep understanding of the population of new buyers and buyers' syndications (corporate, financial and sovereign), so that we can create multi-party interest in our re-purposed portfolios.

On both sides of the buy/sell equation, we have had to conform to established IP business models and practices, and to adapt to new and emerging IP models, sometimes creating new structures in response to special situations. This article summarises some of the more recent IP investment and collaboration models that we have come across in undertaking our business.

We must begin by considering the motivations of the buyer/seller. These clearly vary depending on whether they are strategic corporate investors with a long-term perspective (eg, buying large, wholesale portfolios of variable-quality intellectual property to launch into new business areas) or tactical corporate investors with specific, highly targeted short-term needs (eg, buying litigation-grade, claims-charted patents for counter-suit purposes); and whether the transaction is intended to fulfil corporate business needs or is purely for financial return on investment (this latter category has seen a great increase in activity in recent years, as shown in Table 1). This chart represent our own efforts – notwithstanding the paucity of publicly available information – to characterise the different classes of IP buyers in marketplace, not including operating companies that buy intellectual property for primarily strategic reasons.

Additionally, whether the IP asset is correlated with other corporate assets (businesses, people, technology) or stands alone will also determine the optimal tax/legal structure for the transaction (onshore v offshore; capital gains v income streams; near term liquidity v operating cash flows; on v off-balance sheet). As a private equity fund, this can make the difference between an effective hurdle on returns of as low as 5% to up to 40%, and therefore can significantly affect the financial viability of the investment, however good the patents.

The buyers

To date, one of the most successful, yet often overlooked, categories of IP monetisation stakeholders are technology development corporations such as Rambus, Mosaid, Interdigital, Tessera, Dolby and Wi-LAN. These organisations have deep technical expertise in a narrowly defined field – often borne from previous productisation efforts, now abandoned – and have developed vertically integrated patent portfolios over an extended period. They have generated billions of dollars of revenues for shareholders, but now face significant challenges in sustaining this track record beyond their current generation of in-house intellectual property and through current licensing cycles. In many cases, as their in-house IP research and patent prosecution efforts have not generated the same quality or impact of new intellectual property, they have become net buyers of intellectual property.

Given their cash reserves and growth expectations, we expect to see them very active in 2011/2012, expanding into complementary technical fields and even entering new fields where they have no prior expertise (hence their prominent recruitment drives of late). In terms of structuring transactions, this class of buyer is extremely discerning, likely to cherry-pick single patents which they consider for assertion purposes to fill in gaps in their own litigation blueprint rather than buying larger, more diverse portfolios. They have sophisticated valuation models and have shown themselves willing to pay significant amounts for the right patents. They can also move quite quickly when needed.

Chinese boom

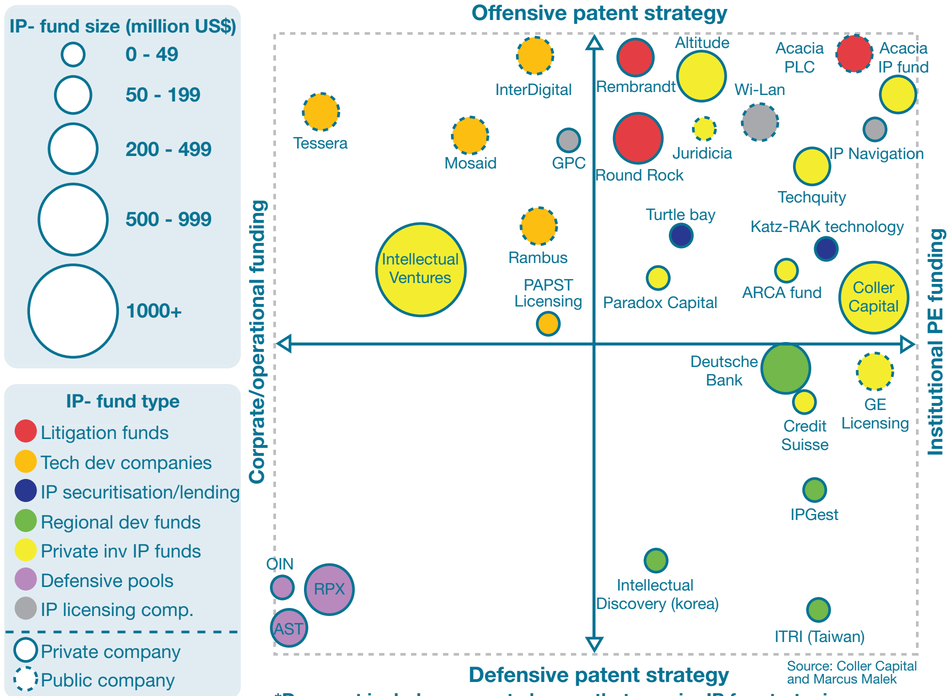
Another major recent category of new buyer, on a scale previously unseen, is Chinese operating companies. Traditionally, they have focused on the burgeoning domestic market. However, underwritten by government funding, flagship companies such as Huawei, ZTE, TCL, BYD and Haier are now aggressively seeking portfolios to hedge their product launches in overseas territories, and in some cases to provide additional firepower in countersuits – a phenomenon that is likely to increase dramatically as Chinese companies become more IP savvy, innovative and quality competitive. The recent Huawei suit against ZTE in european courts is a clear sign of this, much to the chagrin of the Chinese government.`

Given their need to establish defensive cover across multiple business units, this class of buyer is much more willing to buy large portfolios, often through trusted third parties such as agents or law firms. But from a seller's perspective, they suffer from agonisingly slow decision making and a commodity view of intellectual property from a pricing point of view. This will change, we feel, as these companies build their in-house IP competencies (rather than their current reliance on external US counsel, who cannot provide the business and strategic insights on value into their IP acquisition process), and learn to collaborate despite being fierce competitors in their home market.

Some progress has been made in terms of Chinese companies coordinating litigation counsel and sharing costs in response to foreign suits; but it will be some time before RPX/AST-style defensive models solely for Chinese companies are established, despite encouragement from the Chinese government. Meanwhile, Chinese companies are increasingly filing countersuits in the Chinese courts (eg, ZTE's countersuit to Sony-Ericsson in response to suits filed against it in Europe). This has precipitated increased interest in Chinese patents, and we are receiving

“XX”

Table 1. **The IP acquisition on marketplace (illustrative) - The rise of financial/NPE buyers***



*Does not include corporate buyers that acquire IP for strategic purposes

numerous requests from US companies in particular to shore up their defences in this territory in anticipation of these countersuits.

Structuring deals

In terms of structuring transactions, we are resigned to becoming increasingly involved in aggregating patents to arrive at a critical mass of intellectual property in any particular area. The reasons for this are twofold:

- As products and technologies become more complex and integrated, no one company can possibly hold a monopoly on the IP landscape for that particular field – mobile payments are a very real example of this.
- With the cultural shift towards open innovation, more companies are willing to rebalance and supplement their own in-house R&D and patent prosecution efforts with active buy/sell programmes (with very notable exceptions, of course).

By our own estimates, the secondary marketplace for patent sales (uncorrelated) will reach US$2.4 billion in 2011 – a significant up-shift from 2010 – and is likely to grow at a compounded rate of 20% to 30% or more a year for the next few years. This mirrors remarkably closely the secondary market for private equity holdings pioneered by Jeremy Coller and others in the 1980s.

The benefits of aggregation are that you can purpose-build end-to-end solutions targeted to a particular new commercial hypothesis – cloud computing being a very topical example – and the motives for buying intellectual property at a constituent level may not be obvious to the seller(s). Unless the intellectual property is bought outright (recommended where possible), aggregation poses major problems when you try to get multiple parties to contribute their intellectual property in kind into a limited liability company (LLC) type vehicle in exchange for profit participation. This requires great feats of persuasion and a shared vision between the parties.

As well as needing to explore aggregation to build bottom-up portfolios, we have also been compelled to go to non-traditional sources to secure important new intellectual property, such as defence companies, government laboratories and, especially of late, start-up companies. In fast-growing markets such as clean tech and med-tech, much of the innovation has been driven by venture-backed companies. Indeed, whole new industries have been pioneered by dynamic new start-ups that recognised the market opportunity well ahead of the larger incumbent players (eg, social networking, over-the-top media streaming).

In dealing with these companies, we have had to change our expectations in terms of the nature of intellectual property available. It is usually still in the early stages of prosecution and, given that it is core to their business, these companies are unlikely to be willing to sell outright, so exclusive rights for specific fields of use are sought – which is less than ideal for us. Furthermore, given the lack of budget or in-house expertise, we normally need to get involved early on in improving the quality of these portfolios, including reissues to broaden the scope of claims and funding to ensure that foreign filings are made. The benefits are that we align ourselves with seminal IP holders in fast-growing new industries which defy traditional growth trajectories and present early secondary re-sales and licensing opportunities to mainstream players seeking to gain footholds.

Financial buyers are sometimes excluded from high-profile corporate IP divestitures – based on a fear that these assets will somehow come back to haunt them or their partners – and so a common tactic is a private catch-and-release strategy whereby the financial entity bankrolls the corporation to acquire the portfolio, take a licence (at zero cost or highly favourable terms), and then release the assets back to the financial entity for subsequent monetisation in the wider marketplace. Variations of this are, of course, where multiple corporate parties are involved and contribute towards the total principal capital commitment. The converse is true (and possibly more common), with financial buyers leading a syndication of anonymous corporate sponsors, managing all parts of the acquisition process and retaining full ownership of the acquisition vehicle, including post-acquisition monetisation in the marketplace outside of the corporate participants (eg, Nortel had multiple bids of this type).

Litigation financing

One of the fastest-growing segments of the IP funding business is litigation financing. This general group encapsulates several categories of IP operators, from law firms that provide in-kind contingent litigation services (and sometimes capital) to independent funds and private syndications that provide project-based financing for in-house or third-party teams to pursue litigation. Several recent developments are notable in this regard:

- In-house litigation teams from Tier 1 law firms are spinning out into independent LLCs as they seek to evolve from contingent law firm to principal investor and receive a larger part of the rewards; Desmarais LLC is a case in point.
- Taiwanese, Korean and Japanese companies are bankrolling vehicles in the United States (several high-profile suits have some surprising associations to top names) as a means of providing additional tax on competitors' products and supply chain.
- The privateer model was taken to new heights with the Round Rock Research transaction with Micron Technologies. Not only has the subsequent licensing programme clearly been very successful for Round Rock, but the notoriety of the litigation team and the quality of the assets led to the conclusion of at least one well-publicised derivatives deal in March 2011, whereby a covenant not to sue was sold to an undisclosed buyer (not a semiconductor company) for US$35 million via ICAP Ocean Tomo's public auction platform.
- We are also seeing hybrid structures such as the US$50 million Digitude Fund affiliated with Altitude Capital, which appears to be part private litigation fund and part aggregation play with back-end participation to members that contribute their intellectual property. This is a potentially smart strategy to attempt IP holders to pool their assets together for greater impact and participate in future risk sharing, with the promise of better returns downstream.

We have also seen the recycling of several high-profile portfolios which have come back to the market with a different strategy and/or management team. For instance, the Walker Digital portfolio was offered for sale on multiple occasions with little or no interest; then covenants not to sue were offered via public auction, again with no success. Finally, very recently Walker Digital partnered with IP Navigation Group, which provides litigation support services; and in April 2011 the company filed 15 suits against more than 100 defendants, including Microsoft, eBay, Amazon, Facebook, Wal-Mart, Groupon, Apple, Sony and Google. We shall have to see whether this new strategy pays dividends to Walker Digital.

Defensive opportunities

We are also seeing interesting opportunities “xx”

to invest at the defendant end of the litigation equation. Corporations' only recourse to counter the threat from NPEs is to endeavour to invalidate the patents through a re-examination process with the patent office. However, corporations are fearful of estoppels issues, whereby in the event that the patent is deemed to be valid, their liability significantly increases over the subsequent settlement negotiations or ongoing suit.

Re-examination companies (RECos), often structured as LLCs, seek to offset some of this risk by allowing corporations to pay insurance premiums, with other corporate members (often party to the same NPE suit) participating in a defensive pool. The key element to RECos being legally viable, it is claimed, is that the pool entity is independently owned and the *inter partes* re-examination process is managed solely by a dedicated team employed by the RECo. As such, the corporate members are party to the re-examination, but the estoppels liability rests solely with the LLC. There are clearly several challenges to making RECos work as a private equity investment proposition:

- Determining the right annual or per-suit premiums paid by corporate members.
- Negotiating caps on liability to the LLC in the event that settlement payments to the NPE need to be made.
- Risk distribution across multiple paying members and projects.

It is nevertheless a very promising cash-flow business that warrants further experiment, and we have had several corporations inquire about forming these vehicles.

Moving up the private equity chain

As an IP investor since 2006, we have seen intellectual property becoming increasingly pre-eminent in private equity. This has evolved over three discrete stages: from being a nice-to-have asset correlated in venture and M&A deals, to being a major driver of value in these deals (as a major investor in Flarion, which was subsequently sold to Qualcomm, we saw this first-hand), to being explored as an uncorrelated, tradable asset in its own right.

We can only speculate how intellectual property in private equity might evolve in future, but if it is to flourish and be considered a mainstream financial instrument, we need to address specific challenges unique to the private equity world, as well as general challenges shared by all principal stakeholders in the monetisation process:

- Reducing the timeline to exit/liquidity – private equity is in the exit business, not the cash-flow business. Success is measured not only by the absolute returns in investment, but also by the rate of return– achieving a reasonable balance of both is key.
- Managing downside risk – ensuring that even in the worst-case scenario, we get our principal capital returned.
- Finding high-quality off-the-shelf assets or those that offer great development potential.
- Finding high-quality management teams to monetise the intellectual property and scale out.

We try to mitigate these uncertainties in several ways:

- Investing in broad, diversified portfolios across multiple technologies and markets, so that we are never dependent for success on one project, technology or patent.
- Spreading risk across multiple teams and strategies (eg, sales, licensing).

- Striving to achieve a 1x return on our principal capital back in two to three years and 2x to 3x return in three to five years.

Sometimes this means leaving value on the table, but it does ensure smoother, more predictable returns.

As with venture capital, finding good management is central to success, and providing attractive performance incentives (and enough working capital to perform over a given period of time) is the only way to attract top talent, in our experience.

Taking on the competition

One of our biggest fears moving forward, as a financial investor, is price inflation on high-quality assets – especially given the rise of new classes of buyers, such as sovereign IP funds, and the re-emergence of strategic buyers as corporate earnings have recovered. We can never compete directly with motivated corporate buyers with a strategic mandate (and relative price inelasticity) – Google's US$900 million bid for the Nortel assets being a good example; but we can compete in other ways, which may be just as important to the seller:

- Willingness to offer the seller significant back-end profit sharing so that total future value of the intellectual property can be accounted for, rather than short-term liquidity pricing.
- Ability to structure the transaction as a capital gains or income stream event, depending on the balance sheet/treasury requirements of the seller. Tax-loss carry-forward benefits can also be incorporated into the profit-share hurdle negotiations.
- Ability to provide privateer-like capabilities to the seller's competitors in the marketplace.
- Ability to move very quickly and quietly, with the combined IP monetisation, techno-legal due diligence, investment, structured finance and tax expertise closely aligned into a lean decision. It is thus possible to fast-track the deal lifecycle with sellers and offer much more flexible deal structures than corporate buyers.
- Ability to go upstream and spot promising early-stage assets which, while requiring significant reworking, re-examination effort, claims chart development and proofing, can be taken to the marketplace and leveraged relatively quickly.

On a final note, the business models highlighted in this article will invariably evolve in response to the changing geographic landscape of IP ownership. A recent Royal Society report (*Knowledge, Networks and Nations: Global scientific collaboration in the 21st century*, RS 2011) indicated that by as early as 2013, China will generate more scientific output that the United States. It is probable, but by no means inevitable, that over the next few years such momentum will spill over into improved IP citations and quality metrics, and then ultimately realisable IP value. While currently almost half of US pending patents are from Asian entities, their quality index and conversion rate (from pending to granted) remains markedly lower than US and European owners' intellectual property. The rising pre-eminence of Asian companies and research centres' intellectual property will necessitate revised models of technology transfer, intermediation, litigation and pricing. We are both nervous about and excited by the challenges and opportunities that these developments bring to our industry. ***iam***

Action plan

The secondary IP marketplace is growing rapidly, with established and new buyers/sellers emerging.

With the rise of ROI/private IP funds, defensive pools and government-backed funds, as well as the general recovery of corporate spending power, coupled with increased litigation activity, competition for top-quality patents will increase significantly over the next few years. This will necessitate investors doing the following:

- Going more "upstream" to source promising intellectual property earlier on.
- Exploring non-traditional sources of intellectual property and aggregating where necessary.
- Being flexible in terms of investing in different IP business models.
- Attracting top licensing talent and incentivising them well.

Those that survive will need to show deep pockets for follow-on, have an ability to gain access to the serial IP monetisation talent, show extreme investment and market discipline and provide investors with more visibility on liquidity via a multi-strategy approach to IP monetisation.

As the centre of gravity for seminal IP migrates further east over the next few years, new IP investment, collaboration and monetisation models will evolve by necessity.

Peter D Holden is Head of the IP Investment Group at Coller Capital Inc. The views held in this article are the author's alone and do not necessarily reflect those of Coller Capital, Inc