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CAN A SAVVY FOCUS ON INTELLECTUAL PROPERTY GENERATE ALPHA?

By Sherree DeCovny

A major portion of corporate value resides in intangible assets, including intellectual property (IP), and investment strategies increasingly require an accurate calculation of the value of IP. Moreover, IP is emerging as an attractive alternative asset class in its own right.

IP refers to such assets as trademarks, patents, copyrights, and design rights. Users of these assets must sign a license agreement with the owner and pay for the right to use them in their product or service.

"In this sense, it is very close to a hybrid security with equity features (since its income is tied to the revenue or profit of the product or service) and fixed-income features (specifically the periodical payment)," explains Jack Lu, chief economist at Applied Economics Consulting Group, based in Austin, Texas.

KEY POINTS

- IP is protected by law and reflected in International Financial Reporting Standards.
- IP owners can monetize the asset or generate alpha by using insight into its value to make investment decisions.
- Pricing is based on cash flow analysis, although the industry uses some specific tools and data sources.

The right (and accompanying income-generating capacity) are protected by law. If the user refuses to negotiate a license agreement, the IP owner can take the user to court for infringement and can potentially be awarded a large settlement and damages.

Importantly, International Financial Reporting Standard 3 recognizes these assets in purchase price allocation on acquisitions, and it is possible to value and transfer them. As a result, companies are leveraging their IP in new ways. For example, Kelvin King, managing director of U.K.-based Valuation Consulting Company, has helped pension trustees, actuaries, and accountants use IP to fill pension deficits. The pension scheme trustees buy certain IP assets from a company, and in return, they have rights to the assets for a specified time period. The trustees can then receive income from the IP through licensing and franchising. In the U.K., TUI Travel is using the brands Thomson and First Choice as collateral to help finance its defined pension scheme.

IP INVESTMENT STRATEGIES

According to Michael Friedman, managing director of Ocean Tomo, a provider of IP valuation, risk management, and sale/auction services, some investors buy IP to monetize it. Alternatively, investors can generate alpha by using insight into IP value to make investment decisions. IP alpha can be found in the securities of most technology-rich companies. The trick is to find an IP-driven trade idea and then look across the capital structure for the most intelligent, risk-adjusted way to express it.

Common equity or debt is the most liquid way to trade an IP idea. Investors can identify companies in a particular sector that have strong IP and buy their equity or debt. Against that position, they can sell short intra-sector peers with weaker IP.

"Over 9 to 12 months, that deep-value IP catalyst will cause a mean reversion, and your longs will outperform your shorts," says Friedman. "Because you've got a balanced sector-neutral exposure, you have to worry less about systematic risk."

Special situations can present liquid trading opportunities. IP can drive mergers and acquisitions, as when Google purchased Motorola Mobility. Distressed companies are sometimes forced to sell IP assets, as shown in the cases of Nortel and Kodak. A major shareholder activist may demand that the board take action to monetize hidden IP and drive shareholder value. Succumbing to pressure from Starboard, for example, AOL sold US$1 billion of IP to Microsoft.

"The market capitalization of AOL went up US$7 billion, and the stock is up about 127% this year because investors began to realize that there's a lot more IP value embedded in AOL," notes Friedman. "If they continue to monetize it, there's a lot more upside in the stock."

Some market participants invest based on the outcome of IP litigation, but this strategy is uncertain no matter how good the investor's insight into the verdict is. Still, the broad market does not appreciate the effect of IP verdicts on small- and mid-cap companies. It is often efficient to buy volatility in a back spread (where a trader holds more long positions than short positions). The cheap volatility tends to pay off regardless of the verdict because stocks move more than the implied volatility.

IP collateralized lending is among the less liquid strategies. Hedge funds and other players lend against a company's IP portfolio using their IP as collateral. These can be good investments, assuming one can understand the underlying value of the IP well enough to determine the proper loan to value.

IP rights-enforcement investing can be extremely lucrative. In this strategy, hedge funds supply the capital to finance the enforcement of intellectual property that is being infringed by third parties. This investment style started because large companies have been known to infringe on the rights of small inventors who do not have the resources to assert their IP.

IP-driven private equity investing is the last category. Many public companies have strong IP portfolios, but the revenues from enforcement can be lumpy over the long term, making it difficult for them to report pristine quarter-over-quarter straight-line revenues and earnings. To this end, these companies are better off being privately held.

"Increasingly, you're seeing public companies with rich IP portfolios go private either by themselves or with the help of leveraged buyout firms," says Friedman. "We're looking at a number of candidates to do just that."

DISCOVERING OPPORTUNITIES

Several types of companies play a role in the discovery and development of investment opportunities: publicly traded patent-holding and patent-asserting companies (such as Acacia Research Group, Rambus, InterDigital, and Tessera), privately held companies or investment funds that acquire and assert patents (such as Intellectual Ventures), and patent risk management and litigation insurance firms. An example of the latter is San Francisco-based RPX, which is structured like a mutual insurance company. It searches for patents in the business domain of its members and buys them, thus preventing members from being sued for infringement.

Additionally, there are patent brokerage and advisory firms, including Ocean Tomo, ThinkFire, and Innography. Ocean Tomo developed a proprietary quantitative tool that values all U.S. patents weekly. The company also has an application that attributes a patent to the owner. These tools enable investors to assess and act on the changes in the value of IP portfolios. Additionally, the system can map individual patents or patent portfolios based on the quality of the patent and its relevance to other patents in the same and different technology classifications.

Moreover, IPXI (Intellectual Property Exchange International) is being launched to serve as an exchange and intermediary between patent owners and potential licensees. It will list unit license right (ULR) contracts. Each contract gives the buyer the right to use a pre-established unit of IP. For example, the purchaser has the right to make and/or sell up to an established quantity of products covered by the patents in question.

"We hope we become the standardized place where people can go to invest purely in technology, as opposed to investing in the company that participates in that technology through their products and services," says Bob Moore, managing director of IPXI. "We're about as close as you can get to a pure play in a technology investment."

PRICING

Pricing IP is similar to pricing many other assets, although the industry uses some specific tools and data sources. Investors conduct cash flow analysis and calculate net present value (NPV). Usually, they search commercial databases for the comparable royalty rate. According to Lu, two widely used databases are RoyaltySource and ktMINE. The comparable royalty rate is applied to the patents, and necessary adjustments are made, resulting in a royalty rate for the specific patent. Once the royalty rate has been determined, the next step is to forecast the revenue of the targeted products. Finally, determining an upfront lump-sum payment involves calculating the NPV of all future royalty payments.

Each investment strategy has pricing nuances. In long–short debt and equity trades, pricing is based on the IP of a company and the real or potential cash flows it can generate. In distressed special situations, one can build in the effect of the IP selling price on the price of the distressed bonds. In IP collateralized lending, the key is to figure out a likely selling price of the IP in the event of a loan default. IP rights enforcement pricing is based on rigorous analysis of the prospects for enforcement as well as validity. In private equity, the upside case being modeled is based on the ability to derive revenue and income by exploiting the IP.

On IPXI, the offerings will be structured in tranches. Each tranche will be priced at a premium to the previous one, probably about 10%–25% depending on the market demand.

RISKS AND RETURNS

Getting the underlying value wrong or misjudging the embedded value of the asset is one risk that comes with the territory. Another one is legal risk. First, patents can be invalidated by the courts and the owner can lose everything. Second, most patent investment firms and aggregators are non-practicing entities (NPEs)—patent holders that do not use the patents to manufacture products or provide services. NPEs have a tarnished reputation in the high-tech industry and are referred to as "patent trolls." The America Invents Act, which was passed in September 2011, mandated the U.S. Government Accountability Office (GAO) to conduct a study of NPE impact on the patent and legal system. The final results will be released to the public in November 2012.

"If the GAO report is negative on the NPE business model, the risk will be very high," warns Lu.

Still, investing in IP can yield significant returns. The long–short liquid equity strategy can earn 5%–10% over the broad market. The special situations can earn 15%–30% returns. One can expect IP collateralized debt to generate a return of 15%–20% plus warrants. IP rights enforcement can earn a 10x return, and private equity, at least a 6x return.

The importance of IP continues to grow. Because it accounts for a major part of the firm value of many companies today, it is emerging as an alternative asset class that offers new opportunities for investment. For investors, tapping the potential alpha will mean sorting through a variety of strategies and finding the right fit for their circumstances.

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"Alternative Assets" by Jean L.P. Brunel, CFA; CFA Institute webcast, 25 July 2012 (www.cfawebcasts.org)

"Environmental Finance Assets: Emerging Opportunities and Risks in Sustainable Investing" by Richard L. Sandor; CFA Institute webcast, 10 July 2012 (www.cfawebcasts.org)

"An Overlooked Value Driver?" by Sherree DeCovny; *CFA Institute Magazine*, November/December 2011 (www.cfapubs.org)