

HOW INTELLECTUAL PROPERTY CAN DRIVE INVESTMENT PROFITS

by James E. Malackowski

There has been a major structural change in the balance sheets of public corporations.

In the last three decades, the primary driver of corporate value has shifted from tangible to intangible assets. Despite this shift, intangible assets are still significantly under represented, if not entirely absent from corporate balance sheets.

This change has caused securities analysts and investors to seriously misread the underlying fundamentals of many companies. Intangibles can represent both asset value and liabilities substantial enough to significantly affect a company's financial position. The fact that these intangible assets and liabilities rarely exist on corporate balance sheets puts all analysts at a significant disadvantage in thoroughly assessing a company's financial health. The situation is becoming more untenable every day as corporate reliance on intangible assets to drive growth increases and popular myths persist regarding patent quality in the US. Misreading a company's fundamentals by overlooking intangibles can lead to grave errors. Currently, corporations are analyzed using tools bequeathed to us by Benjamin Graham 60 years ago. Yet balance sheets are no longer composed of machines and physical property. They are now dominated by intangibles. We therefore need to throw away or dramatically change the methods we learned in school to take into account this structural change in the corporate world. There is a strong headwind against success for an investor if they don't make these changes. It is quite possible that this structural change is one reason for active managers to be consistently underperforming their benchmarks.

Investors must realize that a proper understanding of intellectual property (IP) can be a solution to many common problems. This book is designed to provide investors with information to more accurately understand the dynamics of the patent assets of the listed companies. Securities analysts can provide unique information to their brokerage clients and portfolio managers that simply isn't available elsewhere. Private equity managers can now more accurately identify the underlying value of a company and even see opportunities that others don't.

IP value, and particularly patent value, is a key factor driving the share price of listed companies. In a very broad sense, IP represents a company's intelligence, knowledge, and character. We can only indirectly measure these critical factors, but we can directly evaluate the IP represented by patents. We have direct and constant, almost real time, access to a company's patent portfolio and their actions around it. This is an incredibly powerful tool for evaluating the patent IP of a company. In a real sense, this tool unlocks the hidden value in public companies, making it available for close scrutiny by investors.

IP is a key driver of stock market outperformance. We can see this clearly when we look at the track record of the OT 300 and the S&P 500. In 10-year backtests the OT300 outperformed the S&P 500 by more than 300 basis points annualized. Through February 2008, the OT300 outperformed the S&P 500 by more than 800 basis points in the trailing 12 months. The reason is clear. The OT 300 represents a diversified portfolio of 300 companies with highly valuable IP relative to book value.

By specifically identifying IP-rich companies with valuable portfolios of patent assets, one can outperform market benchmarks. Investors now have a powerful tool for outperforming the S&P 500. They can buy the OT 300 via direct purchases, an exchange traded fund, or through the upcoming derivatives based on the OT 300. It is, of course, an excellent source of profitable ideas for outperforming the market.

High Value IP Companies Will Tend to Outperform the Market

We know that high value IP companies tend to have high gross margins. Think about such industries as software or pharmaceuticals. These are companies which rely heavily on IP to drive revenues. Gross margins of over 80% are not uncommon in these industries. Higher gross margins mean

higher profits, which drive the price of the stock higher. Strong patent protection helps companies protect against erosion in their margins over the life of the underlying patents.

Further, the more a company moves into a higher quality IP space, the higher the gross margins will become. Once again, this should lead to higher share prices over the long term; therefore, it is very important to monitor both the quality of the IP that a company controls at a given time, and patent pipeline trends exhibited by that company's IP. Are they maintaining their current portfolio? Are they creating or acquiring new IP? Are they efficiently using their IP, i.e. are they capturing the maximum profit from what they have? What is their strategy for developing higher quality IP going forward? What is the company's strategic plan for managing the IP portfolio for shareholder value? What opportunities does management see for monetization of the portfolio assets over the medium or long term?

IP Drives Stock Prices in Other Ways

Patents are the most measurable result of a firm's innovations. Companies with high value patents face a challenge in retaining their best research talent as measured by yield of high quality patent assets. Does the company have an employee retention policy that compares favorably with that of its peers? It is an oft quoted cliché that "People are our most important asset." In fact, it is true. People drive innovation and people translate the innovations into portfolios of patent assets that drive value over decades. From the CEO who decides the company's direction, the researchers who create the IP, to the technologists who bring it to reality, people create and manage the intangible assets that drive stocks.

Another very important consideration is that high value IP often creates limited monopoly market positions. A clear example is a new patented drug that is first in a particular therapeutic application so that the producer of that drug can create huge profits with little or no competition for literally years. Note how the value of the drug drops when patent protection is lost, the monopoly protection has ceased, and competition will hammer down the profit margins. Patents don't give the company a right to make the drug, but they do give the company the right to stop anybody else from coming to market. That right can be worth hundreds of millions of dollars, and its strategic importance permeates every sector of the US economy.

Big Pharma is only one of the more dramatic examples of how IP can drive profits and therefore stock prices. But even smaller companies will gain monopoly or near monopoly profits from IP. Every way that a company can enhance its offering to clients while simultaneously not allowing another company to offer the same thing is of critical concern to that company. Once again, this situation can significantly impact the company's share price.

While it is possible to invest directly in intellectual property, most current mechanisms have significant drawbacks which make them unattractive to most investors. You could buy a portfolio of patents and extract the value through licensing or litigation, but both involve substantial risk, expense, and time and are fraught with complications. In a word, the market needs time to develop appropriate securities and/or derivatives suitable for a wider array of retail and institutional investors. The clearest way to capitalize on the beneficial trends in IP is to do so indirectly by buying stocks of firms with superior IP that are maintaining and enhancing their IP positions.

Correctly valuing the IP on the balance sheet of a company will lead to critical insights on the value of the company that other investors do not see. Correctly valuing the IP through time will allow the intelligent investor the ability to more accurately predict the long term revenues and earnings of companies and therefore more accurately project the future share price. This is hugely important for the investor or analysts.

By their nature, intangible assets are difficult to accurately and consistently value. But with the right information at hand, it is possible to evaluate the quality of a firm's intellectual property (IP), and the best place to start is with a company's patents. This book is designed to provide investors with information to more accurately understand the dynamics of the patent assets of the listed companies.

IP is little understood nor monitored by the market today. Thus, the IP savvy investor holds a significant edge in investment profits.

The bottom line is that the unique information in this book can provide for significantly greater profits and value. This book is for anyone who needs to understand the true value of a modern company.