Written by
Bruce Berman

Higher patent quality hurdles may help some licensing companies to prevail

The best-performing IP stocks have the right combination of assets, business model and size. A few have outperformed the waning bull market, but can they survive the bear?

Bull markets are not necessarily good for every company or investor; nor are bear markets universally bad. The same can be said for patent licensing businesses.

Public IP companies as a group have underperformed most stock market indices through the first three quarters of 2014, and even more dramatically since July 2011, when Rockstar overpaid for bankrupt Nortel's patent portfolio. Adverse court decisions for Vringo, VirnetX and ParkerVision, and higher patentability standards resulting from *inter partes* reviews and *Alice v CMB Capital*, have also left their mark. However, the swing of the pendulum has not stopped a handful of licensing companies from beating their competition and the bull market in stocks. We know who, but not why. While their success might be considered a byproduct of the law of unintended consequences, these outliers reveal something about the nature of public IP companies (PIPCOs) as a sector and the future of patents as an asset class.

The wide range of performance among IP companies is a reflection of their size and their ability to grow and generate revenue. The perceived ability of IP licensing businesses to source and close respectable deals in a timely manner is an emerging benchmark for success. Business models that appear to be equipped to surmount the challenges of recent patent system changes have fared relatively well. They will likely continue to do so.

Flight to quality

Perhaps the truest test of the PIPCO universe (and patent quality) will be a bear market or, at least, a US market correction of 10% or more which, as of the time of writing, appears to be underway. Public IP licensing companies have yet to be tested in this manner. Their rise coincides with a 65-month bull run (the fourth longest since the Great Depression), and it remains to be seen which companies are likely to endure and which have been riding with the bull. Until now, PIPCOs have been more speculative growth plays than value investments. A few may soon get the opportunity to show that they can weather both judicial challenges and market storms, and are here to stay.

"IP licensing companies are a very small part of a larger public equities market," says Mark Argento, senior capital markets analyst at Lake Street Capital, who has been following PIPCOs for almost a decade. "It's largely a case of haves and have-nots. Only a half, or so, are institutional grade stocks because of their size and volume. Business models need to evolve. Investor sentiment is improving. We need to remember there is a difference between long-term investors and traders, and that PIPCOs – a young sector – have attracted mainly traders."

The PIPX Intellectual Property Sector Index for the third quarter, provided to the *Intangible Investor* by Freescale Semiconductor, shows an accelerated downward trend for ParkerVision, VirnetX, Vringo and Unwired Planet, and strong performance for Tessera, Rambus, InterDigital and Universal Display.

As per Argento's observation, much PIPCO performance appears to be tied to size. The businesses in the IP CloseUp 30 that exceed $1 billion in market cap all did well through the first three quarters, some even outperforming the S&P 500, which was up 5%. Most of the rest performed poorly, with the notable exception of Marathon Patent Group, whose share price was up 120% at the end of the third quarter. (Links to both the Lake Street Capital data and PIPX IP Index, with graphs and charts, can be found at www.ipcloseup.com.)

RPX is a stock that is particularly confounding. While its market cap has hovered under $1 billion, its shares are down more than 17% over the past 12 months and are below its initial public offering price It was the worst performing of the seven largest market cap companies in the IP sector. As a defensive aggregator, perhaps the perceived need for RPX's services is on the wane, given strong judicial and US Patent and Trademark Office quality initiatives. Meanwhile, RPX has announced forays into patent insurance, data and *inter partes* review petitions, and CEO John Amster has sold 37,500 shares – not exactly a vote of confidence.

Relative certainty

On the other hand, Marathon Patent Group, whose deal sources and assets are significantly tied to IP Nav, is growing rapidly. Although it has only a fraction of RPX's market value and volume, its timelier model seeks to identify assets and settle litigation efficiently because the new litigation economics require it. Big game hunting, once standard operating procedure for serious non-practising entities (NPEs), is simply less viable these days. It still has a place, but as VirnetX and Vringo will attest, the risk has increased.

A kind of normalisation appears to be taking place in the NPE space. While IP rights and *Alice* have made it more difficult for most companies (and law firms) to collect big damages awards, they have not affected all PIPCOs the same way. Those with quality and capital, and room to grow, are in a good position to prevail. Stock prices are depressed as over-reacting investors adjust to lower patent values, but some smart investors will see this as a buying opportunity. Do not expect the courts to provide much more direction about patents anytime soon. A sufficiently high level of uncertainty generates fewer patent disputes and lower values, which suits most tech companies fine. Until a clearer direction materialises for software and other inventions, I would put my money on patents with the highest relative certainty, and holders with a long-term record of success.

Disclosure: Bruce Berman is a principal in Brody Berman Associates in New York. Brody Berman has advised companies mentioned above, but does not own or trade their shares