The Intangible investor

Written by
Bruce Berman

Cash: Patents' once and future king?

Equity investors are hot for the profit potential of patents. IP holders are hoping that cool heads will prevail.

Wall Street's love-hate relationship with IP rights is heating up. It's in the interest of IP holders to make certain cool heads prevail.

A JP Morgan report on Acacia Technologies (NASDAQ: ACTG), a patent licensing company that barely survived 2003, sheds light on the strengths and weakness of public licensing. By racking up a critical mass of patent settlements and a few forward-looking licences, Acacia has caught the attention of mainstream investors. With the help of Barclays Capital (RPX co-underwriter), the company recently raised another US$175 million in a stock offering. As of press time, it enjoys a US$1.5 billion market valuation.

In an industry that prides itself on the ability to discount almost any type of risk, Wall Street finds IP-centric companies such as IBM interesting; those that license patent rights as their primary source of income, it finds tantalising. The difference is in the financials – especially operating margins, which can be double or higher than those of the average S&P 500 company. Wall Street is also turned on by the explosive growth of Acacia, which for now appears to have established a sufficient pipeline of deals to smooth any significant lumps in its earnings.

Is Wall Street ready to accept the patent licensing business for what it is? Are companies that license for a living sufficiently scalable (and sustainable) for institutional investors, pension funds and the like? Probably, yes.

In recent years a number of companies established primarily for patent income have come and gone. Several were publicly held or tried to go public, hoping to avail themselves of the capital markets. The transparency required for public ownership is less at odds with how an IP licensing businesses operates than at first glance. Disclosure can facilitate good IP practices by demystifying the process and may also encourage the timely resolution of disputes to satisfy earnings expectations.

Acacia seems to have broken the threshold for patent licensors. It has provided apparent financial legitimacy to a business model of which many investors remain sceptical. Acacia's ability to source and settle disputes involving infringed patents which it co-owns as opposed to purchases has taken it far. Some believe that it settles enforcement actions expeditiously because many of its patents are not trial-worthy. It has spent barely US$10 million annually over the past three years to acquire licensing enforcement opportunities, which JP Morgan rightly finds unsustainable. In contrast, Intellectual Ventures has spent US$2 billion or more on its 30,000 patent portfolio.

A recent 44-page equity report by JP Morgan analyst Paul Coster provides a detailed look at Acacia's finances, prospects and the future of the patent licensing industry. It is an excellent report, clearly written and thoughtfully researched, no doubt with some guidance from Acacia executives. Coster makes a strong case for patent licensing, suggesting, as I and others have for the past decade, that a more orderly market for resolving patent disputes provides greater transparency and liquidity to a market that is desperately in need of it. Acacia is a means to an end for operating companies, wary of uncertainty.

According to Coster, Acacia's 50% gross profits and 30% operating margins should improve even further. He observes that "corporations and their patent attorneys recognize Acacia's role in the market and often chose to default licensing negotiations". He expects about 23% revenue growth over the next three years. FY 2011 earnings per share are estimated at US$0.98, against a loss of US$0.38 in 2010.

Some industry watchers believe that Acacia settles early and grabs the cash. In fairness, that it sues first and negotiates later is at least in part a response to the threat of declaratory judgment, which unfortunately is becoming the norm among IT defendants. A licensing business that earns a reputation for settling disputes and generating a reasonable return from a volume of transactions, rather than relying on a few big ones, may be a more workable model than more focused patent enforcement firms such as Rembrandt are willing to admit.

Fast-track market licences may be a reasonable alternative to compulsory licences and all-out litigation war that costs everyone. That this business model may strike fear in the hearts of some law firms is no surprise. Acacia is the leading litigant among non-practising entities, responsible for 10% of the suits. Whatever the reason, it has done a good job of avoiding the highest-cost litigation. Can Acacia eventually serve as a kind of ASCAP of invention rights, a clearing house that provides what parties are willing to live with as opposed to what they demand?

The keys for Acacia as I see them: maintaining patent quality; the need to win big in court every now and then to show licensees it is capable of doing so; and the ability to license on behalf of at least some large operating companies, not just to them.

I have been preaching for the past 10 years that patent holders need to do a better job of explaining and qualifying their wins. For most, their success has more to do with mitigating risk or assuring sales freedom than generating cash flow. In the end, it is about achieving business goals. Acacia's success, unfortunately, encourages Wall Street to focus on direct revenue and obscures the value of strategic patents. Hopefully, that fixation is temporary.

Patent licensing has become something of a symbiotic industry – Acacia is dependent to an extent on RPX's and AST's success, as well as IV's, InterDigital's and others'. They all rely on the high cost of litigation. These patent holders feed off each other by offering diverse solutions to a similar problem. They all need the respect and participation of operating companies to succeed.

Together, these strange bedfellows are conjuring the future of innovation and, for now at least, have caught Wall Street's roving eye.

Bruce Berman heads Brody Berman Associates, a consulting firm that helps to position IP rights, holders and service providers. www.brodyberman.com