Positioning IP for shareholder value

When it comes to using patents to provide more brand and shareholder value, some companies may be getting in the way of their own success. In the following excerpt from their chapter in the book *From Ideas to Assets – Investing Wisely in Intellectual Property* (John Wiley & Sons), **Bruce Berman** and **James D Woods** show how the importance of these patents may be overlooked and under-communicated

Big consumer products companies, such as Procter & Gamble, L'Oreal, and Coca-Cola, often have at least a few and as many as hundreds of patents that play a role in the development of their corporate brand equity. Some of these patents are associated with inventions that are vital to product performance. Tide, for example, is a leading detergent due in no small part to the many US and foreign patents associated with its formulation, manufacture, and distribution. Disney, a strong trade mark enforcer, with a brand value of $32.5 billion and a market value of $60 billion, received 110 patents between 1990 and 1999, only 22 of which were design patents.

This article will explore the relationship between two different types of IP, trade marks and patents and examine the opportunity to increase shareholder value by regarding successful patents more like branded products. It will show that companies known for their brands frequently have accumulated proprietary technological innovation and know-how worth taking seriously, even if they escape the scrutiny of most Wall Street analysts. Those companies with strong consumer brands that do not exploit this side of their intangible asset profile may be doing themselves and their shareholders a serious disservice. Similarly, companies known for their advanced technology and strong patent estate that fail to capitalize on their intangible assets and other intellectual capital by creating a sufficient level of brand awareness may find these crown jewels under-exploited.

Finally, we show how strong branding, such as Intel Inside or Teflon, can complement certain patents and patent groups and help to maximize their licensing potential, enforcement, and shareholder value.


Bruce Berman

Quote

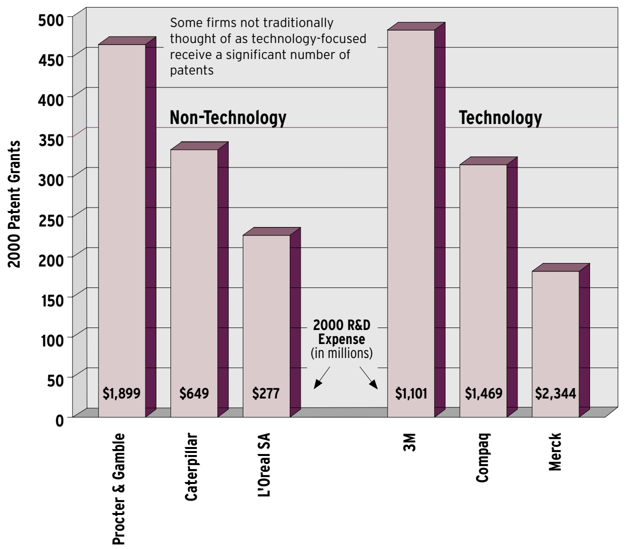
Wall Street's discovery of intangibles

Wall Street has always been interested in how a company creates value for its shareholders. Until recently, value had been defined primarily by profitability, tangible assets, and reputation. Now that intangibles, including patents, trade marks, and other intellectual property, have been revealed as major drivers of value for businesses, comprising up to 75% of companies' wealth, money managers, investment bankers, and others are taking intellectual property more seriously. An illustration of financial community interest in IP is reflected in the increased scrutiny of the topic in the business media. From 1996 to 2000 the number of articles mentioning intellectual property in *The Wall Street Journal* increased by 25%, to more than one article every business day. As IP volume, value, and strategic importance increase, intelligent investors are asking questions they did not even consider a few years ago: what are the firm's intellectual property assets?; what does the IP mean in terms of performance and competitive advantage?; and how are

Box 1:

Brand Builders v Potent Patentees

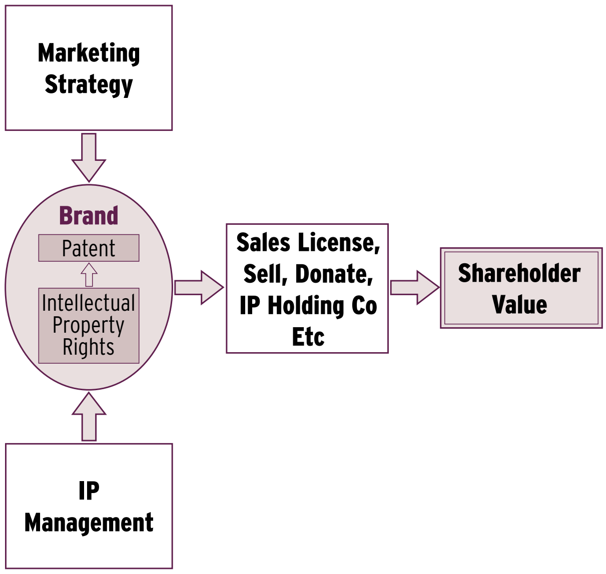
Firms matched on level of sales



Sources: Brody Berman Associate, Deloitte & Touche, SEC Form 10-K and IFI CLAIMS

Box 2:

IP "Branding" Strategy



Source: Brody Berman Associates and Deloitte & Touche

inventions, processes, content, names, and other innovations being managed?

In today's knowledge-dominated economy, perception counts. It is not enough for firms to identify and properly nurture their IP. They must also convey IP strengths to key audiences in the hope of establishing a strong IP brand. Unfortunately, while a few firms have worked quietly (or not so quietly) to establish and maintain IP brand-awareness, most still do not believe that it is necessary to do so.

The primary focus for IP has been on IP management, the identification, classification, and exploitation mainly of patent rights. While these functions are important, it is often difficult for market participants such as investors to translate their results into information that they can readily evaluate. Perhaps equally as important as successfully identifying and classifying IP, maybe even more important, is conveying the results of IP management to key audiences in a meaningful way. Firms that underestimate the interest and intelligence of investors regarding IP and fail to educate, quantify, and communicate, are going to be in for a rude awakening. The failure to convey IP strengths – such as number and types of patent assets, strategy, licensing revenue and transactions, competitive IP position, and successful enforcement actions – can be a major impediment for companies that wish to establish or to reinforce how their inventions and other innovations are perceived. These firms run the risk of being misunderstood in the product marketplace and on Wall Street, or, even worse, understood too late.

A systematic approach to conveying information about a firm's patent strengths – patent branding, if you will – can itself be a source of value in the same way other firm intangibles create value. Typically, firms communicate information about a wide variety of important developments related to their current and future prospects. For example, they announce new products, new senior manager appointments, management's outlook on economic conditions, and overall firm strategy. They also spend tens of millions of dollars in advertising to position their products and identity, to create awareness, and to reinforce credibility. From these communications, market participants develop opinions about the value of a business. If the firm does not include information about IP in its communications, it is leaving out an important aspect of the investment public's information set. IP-savvy firms convey a coherent IP message to their constituents, either explicitly or implicitly. For example, they realize that it is dangerous to assume that stakeholders in patent-intensive companies are uninterested or incapable of understanding a relative position of strength.

Firms interested in maximizing value need to communicate selected information about their proprietary innovations and IP strategy. This can be challenging because patents and IP strategy can be abstract and difficult to describe to those without a technical background or to those who are unfamiliar with the role of intellectual property in a particular industry. Additionally, published financial statements and other public disclosures do not generally include information about IP assets. Moreover, there is little framework and no common language available to help firms communicate about IP. A possible solution is for a firm to systematically educate and convey information about its IP assets, value, performance, and its role in the firm's overall business strategy.

Firm value depends on both IP value and brand value

Firms in traditional technology industries such as computers, semiconductors and pharmaceuticals spend large sums, often a billion dollars or more, on research and develop-

Box 3:

Patent Awards for Consumer Brand Companies

Utility and Design Patents Awards from 1990-1999

COMPANY	2000 SALES (in millions)	UTILITY PATENTS	DESIGN PATENTS	TOTAL
CitiBank NA	$111,826	29	0	29
Philip Morris Inc	63,276	320	24	344
Nestle SA	50,254	635	19	654
Walt Disney Co	25,402	88	22	110
Coca-Cola Inc	20,458	250	119	369
PepsiCo Inc.	20,438	51	12	63
McDonald's, Corp	14,243	0	1	1
Anheuser-Busch Inc	12,262	10	4	14
H J Heinz Co	9,408	4	0	4
Nike Inc	8,995	67	970	1,037
Kellogg Co	6,955	24	7	31

ment (R&D) (IBM, for example, spent $4.3 billion in 2000). However, significant R&D spending is not limited to what are typically thought of as technology-intensive firms. Companies such as Unilever, Procter & Gamble, Ford and Boeing each spend in excess of $1 billion annually on R&D. Significant R&D expenditures often result in the creation of valuable IP. Patent issuance data seem to support this conclusion. Box 1 shows that Procter & Gamble, Caterpillar, and L'Oreal – which are not normally thought of as technology leaders – spent significant R&D dollars in 2000 and were, in fact, awarded more patents than 3M, Compaq, and Merck.

The traditional role of branding in patent strategy is essentially separate and linear. Brand activity occurs near but apart from the deployment of IP rights, resulting in separate revenue-generating civilities. Under a more enlightened or integrated view (see box 2), brand and IP rights are brought together for common activities, potentially yielding greater shareholder value.

Many firms that are not traditionally thought of as technology firms develop significant IP without reporting large R&D expenditures. These firms innovate through less formal means than traditional technology firms, but have recognized the importance of protecting their innovations. The list shown in box 3 contains several large consumer products firms that have a significant number of design and utility patents. Additionally, there is evidence that suggests firms, including Coca-Cola, McDonald's, and KFC (Kentucky Fried Chicken), frequently do not seek patent protection for many inventions, choosing to avoid the disclosure requirements of patent filing, maintaining their key processes as trade secrets, which are protected under state law. It is very possible that IP is more pervasive and important in the economy than the evidence indicates.

Consumer product firms with successful R&D programmes may have a unique advantage in profiting from their patents: the value of their patents may be enhanced by their association with a successful branded product. One theory of the value of a brand relies on the consumer's ability to distinguish easily the branded product and its beneficial features from competing products. Consumers see the brand and know what to expect from the product they are purchasing. A coherent IP marketing-communications programme tied to the brands supported by the patents may increase the value of the IP. Obviously, a potential IP licensor would not want to diminish the value of his or her brand by introducing competition in the market space. However, if, for example, P&G's Tide contained a patented surfactant that could be used in non-laundry applications, P&G may increase its licensing revenue by disclosing the importance of the patent in its successful Tide product to potential licensees. This disclosure may help the licensee value the technology covered by the patent and may ultimately lead to a higher royalty rate. A coherent presentation of all of the firm's strengths, in this case patents and brand value, directed to stakeholders – investors, potential licensees, current and potential shareholders, even employees – conveys value-enhancing information.

Just as it is true that patent management is not uniquely important to traditional high-technology firms, it is also true that brand management is not uniquely important to traditional consumer product firms. Virtually all firms are interested in shaping the way outsiders see the firm's activities and perceive its credibility and value. Many firms rely on a brand image to facilitate perception of who they are and what they stand for. While consumer product companies typically develop an entire stable of brands, each aimed to achieve particular goals, as well as an overall corporate brand, non-consumer product firms generally develop their brand image around a few or, most likely, one concept. This concept is usually then branded with the firm name and a logo.

Several non-consumer product firms have been extremely successful at creating brands. Corporate Branding LLC compiles an annual Corporate BrandPower score, a measure of familiarity and favorableness, for the largest publicly traded companies in the US. According to the 2001 report, the Microsoft Corporation has the highest score, followed closely by The Coca-Cola Company and The Walt Disney Company. There is also evidence to suggest that these

IBM: A compelling IP royalty story

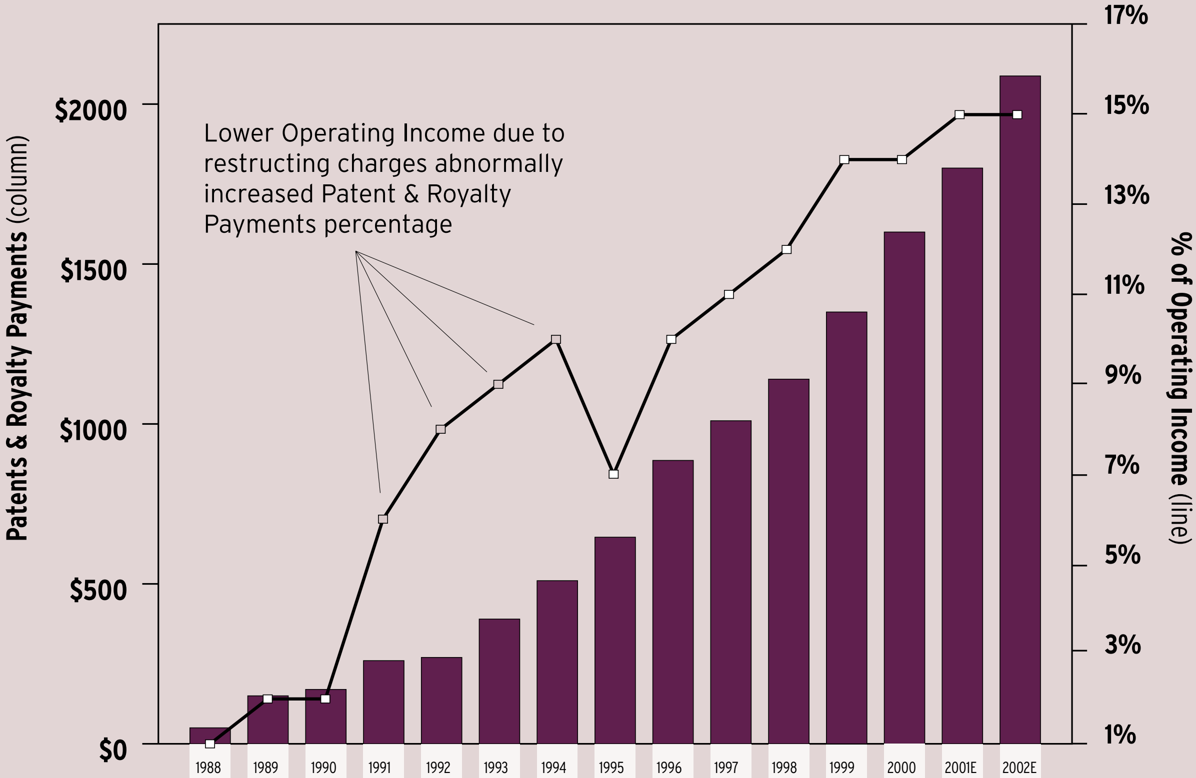
IBM generated approximately $1.6 billion in IP-related royalty payments in 2000. This is believed to be the most income of its kind by any company. While IBM had been generating respectable payments from its intellectual property since early in the 1990s, according to Salomon Smith Barney analysts John B Jones, Jr and Craig A Ellis, additional focus and resources were placed on patents when Louis Gerstner became CEO in 1994. Since then, IBM has been granted the most US patents of any company, a total of more than 13,000. The company has about 34,000 patents worldwide. Of the US total for 2000, nearly 1,000 were awarded for software, 400 for storage, and 1,000 for microelectronics.

Since 1994, IBM has increased its yearly royalty payments, which include software and trade mark licensing, more than threefold. Current projections are based on an estimated 15% to 20% growth rate per year and two times corporate revenue growth, or $1.8 billion and $2.1 billion, for 2001 and 2002 respectively. This represents a very lucrative source of payments – with operating margins of 97% - since the only real cost is a team of attorneys and licensing managers.

According to Jones and Ellis: "Patent and other royalty revenues are passed back to the divisions that generate the IP, with the bulk (Salomon Smith Barney estimates 80% plus) used to offset SG&A expenses and the remaining used to offset R&D expenses. Each $100 million of incremental patent, copyright and trade mark-related royalty revenue decreases operating expense as a percent of revenues by 0.1%. These cost offsets are part of each division executive's P&L plans and provide both divisional and personal incentives to increase the amount of patent and royalty payments."

Additional non-cash intellectual property benefits include cross-licensing the inventions generated by the company's more than 3,400 researchers worldwide. Often, this is a win-win for IBM and the licensee or licensor, since each gains access to the IP that would otherwise be very costly or impossible to duplicate.

Source: Salomon Smith Barney



	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001E	2002E
Patent & Royalty Payments($)	50	150	170	260	270	390	510	646	886	1,010	1,140	1,350	1,600	1,800	2,088
YOY Change		200	13	53	4	44	31	27	37	14	13	18	19	13	16
% of Operating Income	1	2	2	6	8	9	10	7	10	11	12	14	14	15	15

brands are extremely valuable. According to Interbrand, Microsoft, IBM, General Electric, Hewlett-Packard, and Cisco Systems rank in the top 15 of the most valuable brands with an estimated total value of over $200 billion.

Branding has become so important and ubiquitous that even service companies that market their products to other businesses now consider it extremely important. PricewaterhouseCoopers (PwC) and more recently Accenture have both undertaken massive advertising campaigns and developed images of themselves, their goals, and objectives. In 1999, PwC hired 11 well-known photographers to capture images of its partners and staff, and placed advertisements in 150 publications in 30 languages to roll out its new brand image. Similarly, at the beginning of 2001, Accenture spent $175 million to introduce itself after its split from Anderson Worldwide.

Ways of branding IP

To operationalize the concept of branding IP, firm managers must answer four deceptively simple questions:

1) Who are the members of the target audience and what do they want to know about the firm's IP?
2) How should audiences quantify measures of the firm's IP?
3) Which methods best communicate the brand message?
4) Which IP information can and cannot be disclosed?

These questions are easily stated but difficult to answer. They put the burden on management to define how IP fits into the firm's overall strategy, as well as to prove its value and performance without disclosing sensitive information. Doing so requires an integration of the goals and energies of several departments, including legal, research and development, marketing, and finance. Only through a high level of integration can management develop and communicate a coherent IP strategy that will be the foundation of much of the value created through patent branding.

As a first step, managers must determine the composition of the audiences the firm wants to reach – and what BTG CEO Ian Harvey calls their "patent literacy". Establishing the makeup of the audience and its literacy with regard to IP allows managers to determine what the audience needs to know and how best to convey the information. Generally, audiences are made up of the various firm stakeholders, such as investors, customers, suppliers, and employees. Audiences may also include potential infringers of the firm's IP rights and other firm competitors, as well as potential licensees or purchasers of the firm's IP. Audiences will most likely want to know the role IP assets play in a firm's profits and what the company is doing to secure new IP. Much of this information is found through traditional IP management activities such as identification and classification of IP and by analyzing research and development activities.

Secondly, while identifying the correct audience and explaining the role of IP may be helpful, it is probably insufficient to support an IP branding effort. Participants in today's marketplace desire statistics to quantify the information that is being presented before it is incorporated into their decision-making process. To satisfy this desire, firm managers should provide the audience with measures to quantify aspects of the IP portfolio that managers determine are important. Additionally, to provide a frame of reference for the audience to gauge the various IP statistics, management should provide a set of suggested benchmarks or peer group statistics. These points of comparison should illustrate management's conclusions concerning IP and their IP strategy. The benchmarks also would be helpful in highlighting areas where the firm has been successful and areas that may need more attention.

Thirdly, managers must determine the most effective communication vehicle for information about IP value and performance. Management must carefully select the medium used to convey the information. Firms that can help investors understand IP in, for example, a section of their annual report will help themselves. Such communication is relatively inexpensive since it would be part of a generally required document that is distributed regardless. Additionally, most large firms have a review procedure established for ensuring that the information contained in the report accurately portrays management's strategy and goals. While the annual report is an excellent communication opportunity, it is not the sole medium available. Press releases, analyst conference calls, websites, advertisements, and product labels all provide opportunities to convey information about the firm's patents.

Obstacles to branding IP

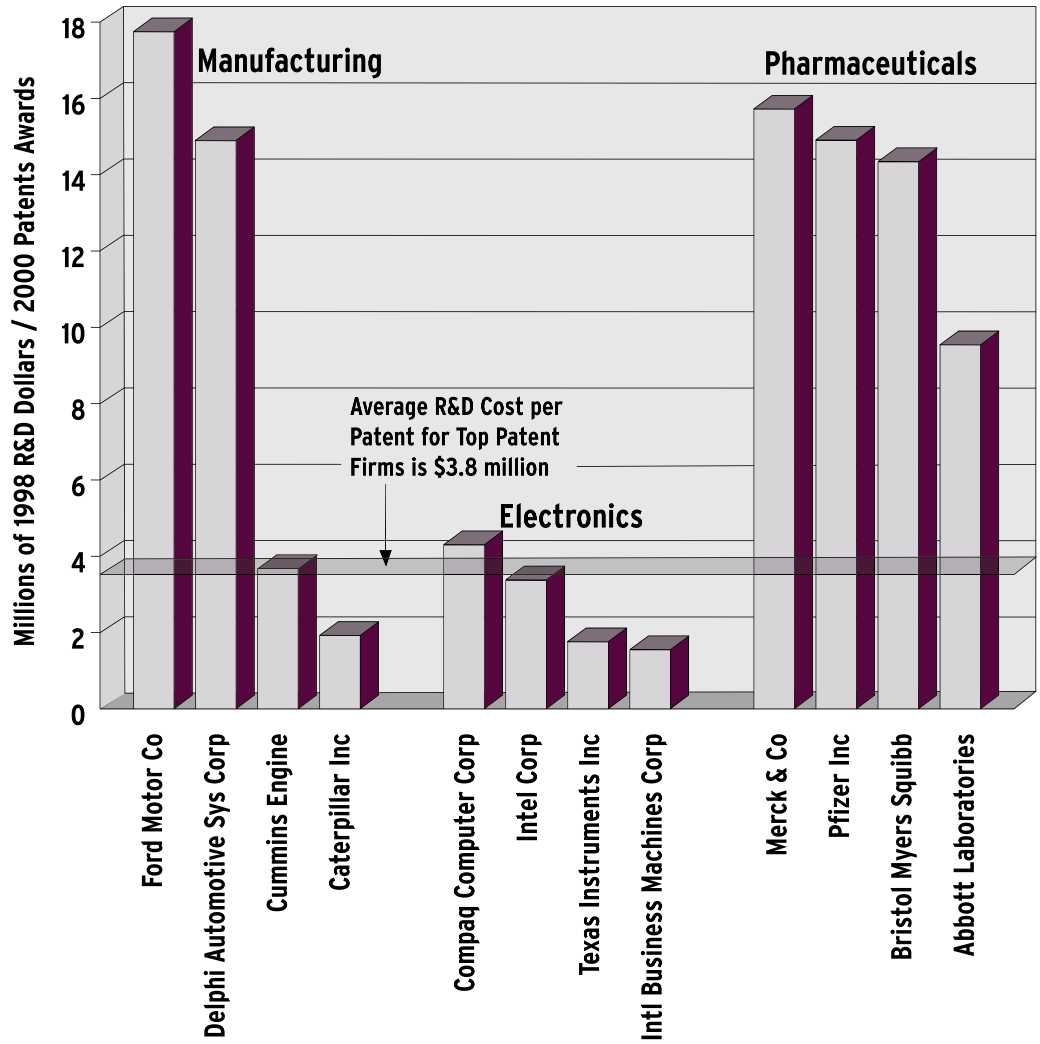
While there is little doubt of the value of IP and the importance of brands and brand management, there appear to be few examples of firms that have attempted to brand IP. This lack of IP branding is the result of several obstacles. Some of these obstacles involve the nature of IP itself, others are internal to the firms that own the IP, and others involve the environment outside these firms. One of the biggest obstacles is that since IP, particularly patents, is abstract and difficult to define, developing a brand image requires the right language and tools. The term 'IP' has different meanings depending on the type of proprietary right, the context in which it is used, and especially the industry. This ambiguity makes developing a consistent brand image difficult. However, this difficulty is exactly the reason branding IP could be valuable. It is up to managers to construct how they want their audience to view the firm's IP. The use of the concept of branding can help present this image coherently and to frame its presentation by the goals of the organization.

Another potential obstacle to IP branding is the differing role IP plays in various industries. For example, in the pharmaceutical industry, R&D expenditures are high and since pharmaceutical patents cover the manufacture of substances shown to be effective in treating specific diseases, the ratio of patents to products is low. This implies that one would expect to find that pharmaceutical patents are relatively easy to value and that this value can be quite large. This conclusion is supported by the blockbuster status of drugs such as Lipitor and Prozac, which have earned their owners billions of dollars. Contrast the pharmaceutical industry and its expensive (but effective) home run patents with the semiconductor and related industries, where a great deal of cross-licensing typically occurs. These differences indicate that the various firms are pursuing different IP strategies. If these strategies are not conveyed in proper context, then it may be difficult to develop a patent brand.

Not only are the number of patents different, but the R&D cost per patent varies as well. Box 4 indicates that manufacturing firms' cost-per-patent varies widely. While pharmaceutical patents may be more expensive than average, the variance between cost-per-patent at each firm is relatively small. To effectively develop a brand, management must help investors understand why these differences occur. This requires communication about the goals

Box 4:

Average R&D Spent per Patent Award



and progress of the R&D department and information about the firm's patent strategy. Since releasing this information may help the firm's competitors determine their best strategy, management may, as a matter of course, resist releasing it.

Finally, views and biases held by the public affect firms' ability to communicate the value of their IP. Often, IP only attracts attention when litigation is involved. Patents are only seen as valuable when it is observed that their existence makes someone pay. On average, investors pay dearly. Indirect costs associated with litigation include the bad publicity or pitchfork effect (as opposed to the halo effect) that follows conflict and strife. For example, one study showed that the combined market-adjusted value of the firms fell by an average of 3.1% within two days of their reported involvement in a patent suit. Another study found a 2% drop. The latter study, which sampled 530 Massachusetts companies, showed an average loss of shareholder wealth of $67.9 million and median loss of $20 million.

The importance of IP information

Many of the obstacles to branding IP such as the different meanings of IP and the variances across firms and industries are also reasons why it must occur. Market participants' misconceptions, and opaque corporate decision-making processes, create an environment where well-structured and consistent messages about intangible assets are valuable, if not rare. Yet, many firms do not disclose even the most rudimentary and benign information about their IP or IP strategy. It is naive to think that by saying as little as possible about a firm's ability to innovate successfully and to articulate its IP position, investors will not form an opinion.

Extraordinary sales, earnings, and share price often speak for themselves. However, performance is rarely that black and white. In an increasingly knowledge-dependent economy, investors need help understanding the role intangibles play in company success. Sophisticated stakeholders (investors, both internal and external, executives, competitors, dealmakers, and potential infringers) form opinions about a firm's IP regardless of whether or not management chooses to strategically communicate the value of the firm's intangible assets. In the absence of information, investors will value the firm based on their vague or misguided opinions of value regardless of whether these impressions are well-informed or not.

Given the success of branding consumer and industrial goods, branding key intangibles, such as patents, proprietary lists, content, names, and even trade secrets, is a logical next step. The development of a coherent IP brand image provides a foundation that supports stakeholders' impressions and opinions of the IP strength and value of a firm. The image creates a structure that allows managers to deliver complex messages over time and provides an opportunity to ensure that the firm is correctly valued. Considering the difficulties associated with defining intangible assets in general, IP branding provides an efficient method that helps key audiences process important information that is sure to play a role in their investment decisions.

Just as IP can be an asset, so too can IP information. Actively managing information flow fosters a positive IP image and minimizes misconceptions. Firms that fail to identify and manage information associated with innovation and proprietary knowledge can expect to see a material decrease in their valuation and performance – a situation for which no manager or investor would care to be held responsible.

 Bruce Berman is president of Brody Berman Associates, Inc in New York. James D Woods is a senior manager in the financial advisory services group of Deloitte & Touche, LLP in Houston, Texas. This article is an excerpt from the book From Ideas to Assets: Investing Wisely in Intellectual Property, edited by Bruce Berman, and published by John Wiley & Sons, 2002.