PATENTQUARTERS™

The Newsletter of O'CONNOR & COMPANY • Second Quarter, 2007

How Much Is Your Patent Worth?

Patents are official titles providing exclusionary rights to technical subject matter expressed in words in the claims. To the non-patent practitioner, patent specifications and claims can be difficult to understand. And even patent practitioners can debate what exactly is and is not covered by a particular claim, based on the inventor's description; or what should be allowable in the first place, in light of the prior art.

But then there is the question about *economic value* of a claim. After all, patents are business tools and should only be pursued when they are predicted to have positive net value. How can the value of a patent claim be predicted?

Inexperienced inventors (and investors) sometimes believe that a granted patent will inevitably lead to making a lot of money. This is certainly not true! The value of a patent depends on a large number of factors.

Single patents, and even single claims, can indeed be worth a lot of money, especially in pharmaceuticals. A market value of the patent on a pharmaceutical can be deduced from the loss of market capitalization of the company which owns the patent when the patent falls into the public domain or is invalidated by a court decision, thereby allowing low-cost generics to compete. An adverse court decision shortening the term *by three years* of the patent on its flagship product appears to have caused the market capitalization of Eli Lilly to fall by **36 billion dollars**!

Perceived value can be worth a lot. In many industries, the "patent-pending" status that you immediately gain by filing a provisional patent application can be worth much more than the true blocking or licensing value of any ultimate patent that issues. Some investors merely want to see large numbers of patents. "We have 25 issued patents and 75 pending applications globally" just sounds impressive, despite the fact that the number of patents should be less important than the strength of specific allowed or allowable claims.

Still, when entering into negotiations to buy, sell, or license IP, some attempt at valuation should be made. It is recognized that the majority of the value of technology companies (and increasingly, all companies) lies not in their physical assets but in their intellectual assets. Nevertheless, IP valuation is often neglected or even ignored because it is hard. Pages 2-3 of this issue of *PatentQuarters* describes various valuation techniques and suggested best practices.

We believe that cultivating the ability within your organization to properly analyze and value IP (both your own and that of your competition) is itself an intellectual asset that creates an advantage for you. ***PQ***

Choose Wisely: How IP Value Depends on R&D Strategy

When valuing intellectual property, the question arises of how the IP will be exploited. This is true whether the IP is being valued for financial-reporting purposes or to support company decision-making. This article[1] focuses on the valuation of actively managed IP to support corporate decisions such as capital investment, business development, and project management.

Whether it consists of patents, technological know-how, trademarks, or copyrights, IP is essentially worthless unless it can create and maintain future cash flows. This particularly applies to IP that is actively used—for example, to support business creation and development.

To place a value on a patent that protects a technology for which there is currently no commercial use, its application(s) must be known. Some will argue that it is too early to do this. But even without attempting quantitative projections, a patent cannot be valued without understanding its potential uses.

Market Approach to IP Valuation

Under this approach, market information is used to determine what others paid, or are willing to pay, for similar IP. Transaction databases, which are often proprietary and focus on specific areas, support this type of analysis. There are several challenges with the market approach. For example, a royalty rate is not the value of the IP. It is still necessary to estimate future sales to which the royalty applies.

Cost Approach to IP Valuation

The cost approach attempts to determine what was spent to create the IP or how much would have to be spent to re-create it. The value of the IP, by this method, is assumed to be at least equal to what a buyer would have to pay to avoid creating it from scratch. However, the cost to create IP is not the IP value. The cost may not account for future benefits to the IP owner.

Income Approach to IP Valuation

The income approach addresses many of the challenges discussed here by considering how much value the IP will generate for a business. The incremental cash flows resulting from use of the IP are projected. There are several ways to do this projection:

- The excess-earnings method, in which the cash flow of a business is valued with and without the IP, and the increment is the IP value.
- The relief-from-royalty method, which values the future royalty payments avoided by not needing to pay license fees.
- The premium-profit method, in which the incremental effect on net revenues of a price premium attributable to the IP is valued.

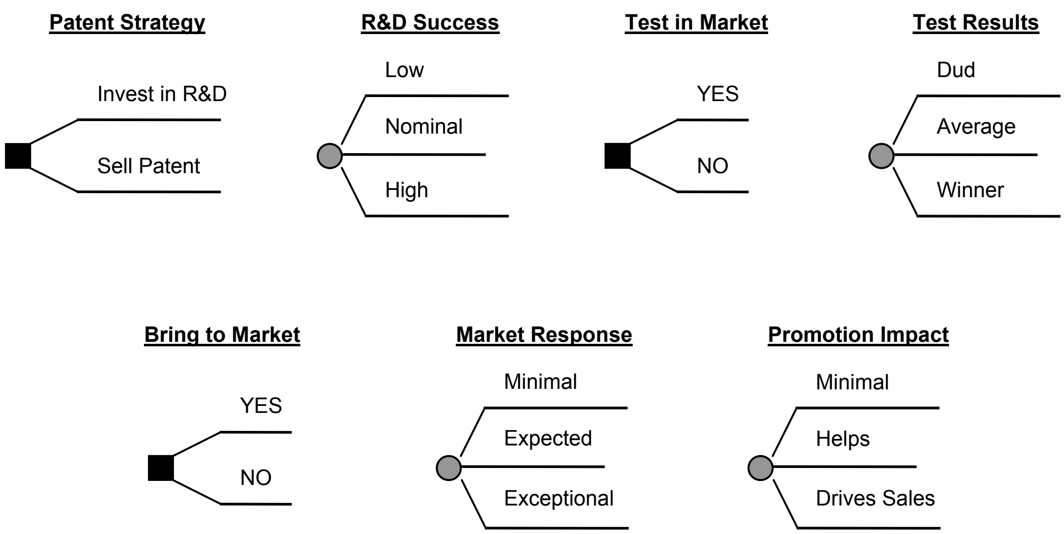
The income approach is appealing in that it focuses on financial value to an IP owner. The challenge, of course, is to model and project future cash flow properly. Projected cash flow is sensitive to a number of drivers, many of which are uncertain.

A Better Way to Value IP

The key to improving on traditional approaches is to quantify risks and capture management options. Risk is inherent in turning IP into cash flow. Risks include unknowns during the R&D phase, such as performance characteristics. R&D costs and timeframes are often uncertain, and in a competitive environment value is sensitive to being first to market. Commercial uncertainties include the level of consumer acceptance and the price and performance of competing products. The very size of the future market may be uncertain.

Given how critical risk is to IP value, it is surprising how often valuations either mention risks without quantifying them or ignore them entirely. Management options are also fundamental to IP value. Should the intellectual property be developed further or sold? How much should be invested and in which markets? All options have differing costs and risks.

Valuing alternative R&D strategies provides significant insight and helps an organization choose the best path. Real-options valuation—an enhancement to traditional income-approach methods—considers future management options. The figure below illustrates this approach, with options shown as boxes and uncertainties shown as circles. Decisions on whether to market-test your product can be decided at a later date once the success of the R&D program has been seen. This adaptive strategy maximizes the IP value.



This approach accounts for how well management adapts to the future. In traditional valuations, downstream investments in test marketing and product launch are typically baked into the analysis. This leads to inaccuracy, since the costs of these investments would not be incurred unless future outcomes warrant them.

When risks and options are explicit, there is better understanding of what drives value, and this knowledge identifies the best R&D path to embark upon. Transactions involving the subject patents, trademarks, proprietary know-how, and so on can be structured to allocate risk and value properly between parties. The IP owner gains a management roadmap that shows exactly which outcomes to monitor and what response to take. Having this roadmap helps prepare the organization to take different roads when needed.

Conclusion

When valuations consider future options that respond to risks as they unfold, the organization gains an explicit roadmap for the intellectual property. The roadmap focuses the organization on key issues to watch for and prepares it for the best response when R&D results are better or worse than was hoped for. The result can be more nimble, adaptive, and streamlined management that delivers maximum value to shareholders. ***PQ***

---

[1] This article is an abbreviated version of the original appearing in *IP Value 2007: Building and Enforcing Intellectual Property Value—An International Guide for the Boardroom* by Rick Schwartz and Frank Bollmann, global experts in IP valuation and directors at Duff & Phelps.

Looking for Venture Capital?

Many of our clients ask us about potential sources of funding to turn their innovations into new business ventures. One source of funding can be venture capital. Upon request, O'Connor & Company can e-mail you an Excel database of U.S. venture-capital firms. The database includes over a thousand firms (with contact information) specializing in various funding amounts, types of company/industry, and geographies.

Just send us an e-mail or give us a call to take advantage of this free service! ***PQ***

USPTO Video Now Available Online

Last fall, the United States Patent and Trademark Office (USPTO) released a professionally developed video that gives basic information about the U.S. patent system and the Patent Office. The video can be viewed and downloaded from the internet at: www.uspto.gov/video/index.htm (see "Promoting Innovation—Today's USPTO") and ftp://ftp.uspto.gov/pub/opa/uspto_video.zip.

Check out this half-hour film which can be good for education purposes (including grade school and college), for inventors and start-ups, or for anyone wanting to learn more about how the U.S. patent system works. ***PQ***

Contact Us!

O'Connor & Company
2608 North Saunders Lake Drive, Suite B
Minnetrista, MN 55364
Phone: 1-612-708-5086
Fax: 1-866-586-5349
E-mail: info@oconnorcompanypllc.com
Internet: www.oconnorcompanypllc.com

"Intellectual-property strategy consulting and patent prosecution for the chemicals, materials, energy, and biotechnology industries"

U.S. Patent Bar Licenses 56692, 56693

Legal Notices

This newsletter is provided as a free service to our clients, associates, and friends. No client relationship is implied by this newsletter, and it is not to be construed as legal advice. We assume no liability for any opinions (expressed or implied) or information contained herein.

O'Connor & Company is a Minnesota professional limited-liability company (PLLC).