Tips for ensuring value of IP rights is recognised in technology M&A

By **Robert Aronoff,** Pluritas, LLC

IP rights play an increasingly important role in technology-related mergers and acquisitions. They will play an even greater role as the importance of patents and other IP rights increases and the ability to define the value of intellectual property becomes more efficient.

This chapter offers best-practice tips for the diligence, valuation and integration of high-technology-oriented intellectual property in transactions, with the hope of helping companies to achieve more successful M&A outcomes.

Better integration of IP diligence and analysis will deliver more success

In a 2014 KPMG survey of 1,000 M&A professionals in the United States, almost half expected to be pursuing M&A transactions in technology, media and telecommunications in the upcoming year. Of those, 85% also saw intellectual property (including patents, technology and know-how) as having a significant to moderate impact on the economic terms of the transaction. Unfortunately, existing M&A processes do not allow for sufficient analysis of the potential value contributed by intellectual property. Indeed, almost 60% of respondents to the survey cited insufficient time as a major obstacle to comprehensive and careful due diligence of the intellectual property. Almost 70% of respondents also admitted that they do not always have sufficient resources to review and value the intellectual property in question properly.

Starting on the IP analysis early in any M&A process will make a big difference. Competent support staff should get the basic effort underway without delay. Immediately that consideration of the opportunity starts, a complete schedule of the IP assets should be assembled. For patents, basic information such as complete US and international patent families should be compiled, expiration dates for the patents calculated and summaries of what the patents pertain to created. The appropriate technical and legal support resources should be secured. Public materials offered by the sellers should also be gathered and reviewed.

Getting IP professionals involved early still does not guarantee that the IP analysis will be appropriately in-depth. It is also important to assess proactively the diligence and valuation effort required and to allocate sufficient resources. Some companies may have only a modest amount of intellectual property – no issued patents, perhaps a small handful of patent applications and technology transfer of minimal perceived value to potential buyers. Others have significant holdings of issued and pending patents, as well as potentially valuable technology and know-how. No analysis can be accurate when based on a rushed and superficial effort.

An experienced IP analyst lead should be assigned to each deal. At times he or she may act as both advocate for and manager of the IP analysis throughout the entire M&A process. He or she should work to drive initial analysis and valuations to completion quickly – which is best done well ahead of any M&A transaction response deadlines. This allows for potential reconsideration

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of initial screening decisions. Potentially valuable intellectual property can easily be missed since it can be hard to understand the nature of the invention, as well as its potential beneficial impact. Interested parties should be informed as to the outcome of the initial review. If a reasonable case can be made for taking another look, consider doing so. Perhaps the seller has created additional analysis that explains why its intellectual property should be considered more prominently in relation to the opportunity. Allowing for reconsideration of the intellectual property helps to reduce potential faulty analysis based on the insular group thinking or myopia that can build up in an evaluation team. It also embraces the most important reason why a company is engaged in the M&A process to begin with – not all innovations and potentially successful ideas are generated from within. Top-quality third-party analysts can help you to see the value proposition of the intellectual property through a more informed perspective.

If a rational seller has invested in the creation of more sensitive IP analysis, consider signing an appropriately structured non-disclosure agreement to gain an in-depth understanding more quickly and more cost effectively. If a buyer is careful, it can avoid contamination related to any potentially overlapping business interests while gaining important insight and efficiencies. It must just make it clear what it is and is not willing to look at under the non-disclosure agreement.

The most challenging analysis relates to understanding how the patents and other IP rights provide leverage and advantage to an existing business unit into which the acquisition might be absorbed. This requires a commitment by the business unit to collaborate closely with the IP group to flesh out the benefits that might be attainable from actually integrating the intellectual property in question.

As the collaborative analysis proceeds, be mindful that intellectual property can add value to the company in more than one way. Considered by itself, valuable intellectual property can sometimes seem incremental, modest innovation. Yet smartly collecting related intellectual property together and being able to build on top of it can deliver significant value for the company. Many patent rights can be strategically leveraged without being litigation grade or licensing ready on the day they are acquired. Such intellectual property can be meaningful for licensing and cross-licensing activities in the not too distant future. Some R&D and innovation gaps can also be filled by acquiring patents, technologies and know-how. When accumulated wisely, these options to innovate can be the lifeblood for the continued relevancy and future survival of a company.

Be sure to complete IP risk analysis related to the target acquisition itself. If the buyer assumes that it will successfully acquire the company and integrate its technological intellectual property, it should also explore any potential gaps in intellectual property related to that acquisition. Perhaps on acquiring the company the buyer may turn into a target for licensing or litigation actions by various third parties. This does not necessarily mean that it should not carry out the acquisition; knowing the acquisition's IP needs upfront allows the buyer to increase its likelihood of success by plugging holes in the combined IP holdings before the rest of the market can exploit such gaps.

Budgeting and staffing in-house make sense if the enterprise has a steady flow of M&A opportunities to evaluate. Even then, a number of procedural and data collection-oriented tasks can be outsourced cost effectively. There will also be times when the analytics need to be improved or, alternatively, the demands are not consistent enough to warrant internal staffing. In such situations, bringing in outside third-party IP business transaction experts is the most prudent and cost-effective decision. Regardless, a buyer should be sure to integrate experienced business and technical people closely with the lines of business in order to ground the entire effort in the real challenges and constraints faced by the company. Further, experienced IP professionals should always be involved in negotiating the IP-related terms of a deal.

Better valuation of intellectual property in the M&A context

Traditional valuation methods used in M&A do not value intellectual property appropriately. A 2008 K&L Gates and CRA M&A survey concluded that "IP value is not fully reflected in traditional valuation methods like cash flow projections". Specifically, "exposure to patent litigation, freedom to operate and strength in key markets [are all of great] importance, and yet all of these factors are overlooked or not readily incorporated by traditional valuation models".

The valuation of intellectual property, like the valuation of innovative high-technology companies themselves, is part art and part science. Value can range widely, depending on how intellectual property might be leveraged and the context of the moment in which it is being valued. It can be of relatively modest value to one company and of great value to another. Value is determined by how the acquiring company can leverage the intellectual property today and in the future. Given that every situation is unique, properly modelling the value of the intellectual property takes time and iteration. To achieve a valuation that is bought into across the organisation, business units and technical people must work closely together with IP professionals. Make an initial investment in the modelling, challenge its accuracy and then revise it until it feels right. Such collaboration vastly improves the end result.

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The C-suite should set the tone for the valuation effort by asking questions that motivate thorough analysis. The focus must stay on how the intellectual property might help to grow and protect the company through:

- freedom to operate or differentiation in products and solutions;
- pricing, cost or margin improvements;
- licensing revenues or savings over time;
- market leverage;
- penetration of new markets and new accounts; and
- options to innovate that support ongoing market relevancy and survival.

Experienced IP transaction professionals can deliver reasonable estimates of the value gained in cross-licensing, in the avoidance of patent litigation, in freedom to operate and in market leverage benefits. They will create robust models that assign probabilities and marginal contributions to a range of potential events that would gain value from intellectual property, such as the likelihood of attaining certain licensing savings or revenues, or the marginal contribution of potential new features and capabilities to the *pro forma* forecasts of the business unit.

A business unit has many more ways that it can extract value from the intellectual property than a non-practising licensing entity, which can extract value only by licensing and enforcing. It is the powerful combination of the patents, technology and know-how working together that delivers the opportunity for enhancing sales, marketing, licensing, R&D and operations. For that fundamental reason, intellectual property is most consistently valuable when coupled with and supporting meaningful, established lines of business. It is still true that uniquely strong intellectual property can be leveraged into highly profitable licensing streams that are sometimes more broadly licensable independently of the constraints that come with product and solution commercialisation. That is simply harder and less common than extracting the value contribution of the majority of IP assets to bolster and help make longer-lived product and solution companies.

The acquisition of Motorola Mobility Inc by Google is a notable example of the potential of marrying intellectual property to profitable operating businesses. Over many years of operation Motorola generated a world-class patent portfolio. Motorola also utilised that portfolio to help to protect its market position and revenues. Then, in 2012, after Google failed to acquire the Nortel patent trove, Google made a quick, bold move and acquired Motorola for $12.5 billion. Given the stakes involved, Google obviously felt that it was important to counter its competition quickly before its lack of significant intellectual property in handsets could be leveraged against it. The value of the patents to Google in that moment of perceived great strategic need was approximately half of the purchase price paid for Motorola. To IP professionals, the price paid by Google was clearly not based solely on the cross-licensing value of the patents in question. The patents and technologies protected the strategic Android handset ecosystem specifically, but the adjacent and hugely profitable advertising business also benefited. Google subsequently agreed to sell the Motorola handset hardware division to Lenovo, keeping Motorola's patents to help protect its future profits from being constrained by competitors. Google's actions clearly demonstrated that intellectual property is most valuable when it is seen as of strategic value to an operating business.

Of course, most M&A deals are not billion-dollar deals. Most M&A deals involve larger companies acquiring small to medium-sized enterprises (SMEs). In the KPMG survey, 77% of buyers projected that the average enterprise value of companies to be acquired would be less than $250 million. Regardless of the relatively smaller stakes involved, SMEs which have invested wisely in their intellectual property have also significantly benefited from their investments in the final outcomes. Intellectual property can contribute between one-quarter and one-third of the transaction value and, in rarer cases, half or even more of the total transaction value.

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Be aggressive, plan for and execute exploitation of intellectual property

The characteristics of intellectual property are unique: it is not like cash, real estate or inventory on a company's balance sheet, but rather is a perishable asset. Intellectual property must be used and invested in, or its value is lost. Immediately on acquiring IP assets, a buyer should mobilise to extract the potential value before it expires. Get this done while the transaction and its original vision and objectives are still being supported by the key people who helped to make it come together in the first place. Much of the value achieved may be hard to quantify exactly. There is considerable value in the avoidance of market and revenue disruption (eg, Google with Motorola) and in avoiding licensing and litigation. Still, a buyer should plan and execute with the goal of achieving between one-third and half of the expected value in the first four to five years, post-acquisition. The intellectual property should not just be put on the shelf. A specific plan is needed to deploy and leverage these unique assets in the most efficient manner.

Contributing profiles

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Robert Aronoff is managing partner of Pluritas, a well-respected IP business advisory firm that has been active across a wide range of IP diligence, valuation and transactions since 2004. Mr Aronoff graduated from Brandeis University with BAs in economics and computer science, and from the MIT Sloan School of Management with his MBA. Mr Aronoff draws on more than 25 years of hands-on experience, having served in various operating and strategy roles in Fortune 500 companies, technology consulting firms, standards consortia and small-cap public companies. In previous positions he oversaw product development, technology strategy and technology licensing. As managing partner at Pluritas, Mr Aronoff provides clients with deep insight into assessing and valuing IP assets, in addition to strong negotiating skills and contacts.

Sellers prepare

Comprehensive IP value-add should be presented from the start when introducing the company to potential buyers. Properly positioning the potential of the intellectual property will significantly enhance the company's chances of concluding a win-win M&A outcome.

A buyer's IP diligence will follow the timeframe afforded in the M&A process. In most IP-savvy companies, the first-pass IP diligence typically occurs in 30 days or less. This diligence is completed quickly – and not always accurately – and creates a strong first impression of the IP value in the transaction.

Accordingly, sellers must positively influence the effort as much as possible. To accomplish this, sellers must do more than create a list of their patents and trademarks and a data room for diligence of contracts and other encumbrances. Just as with the company vision, strategy, products and solutions, a seller must present the merits of its IP assets in a more comprehensive way. Sellers must analyse, package and present their intellectual property knowing that buyers may lack the time, resources or expertise to evaluate its potential fully. This includes presenting:

- market leverage and value analysis for patent assets;
- time-to-market and quality improvement analysis related to know-how and trade secrets;
- the value of copyrights and software assets, trademark and domain assets; and
- technology transfer analysis related to the benefits of adopting the technologies acquired.

Winning the game

There is clearly a big pay-off to embracing detailed IP analysis in M&A transactions. Companies that are proactive and leverage the value of the intellectual property will gain a competitive advantage in M&A transactions. They will be able to exploit their advantage to bid more cleverly than their competition, deliver more closely on the envisioned acquisition expectations and achieve a better and more informed transaction outcome. Companies that recognise and capture the value of intellectual property in M&A are simply playing the game better and should be expected to enjoy more success in the coming years. iam

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