

Using IP to Position Your Company for a Liquidity Event



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Agenda

♣ Topics

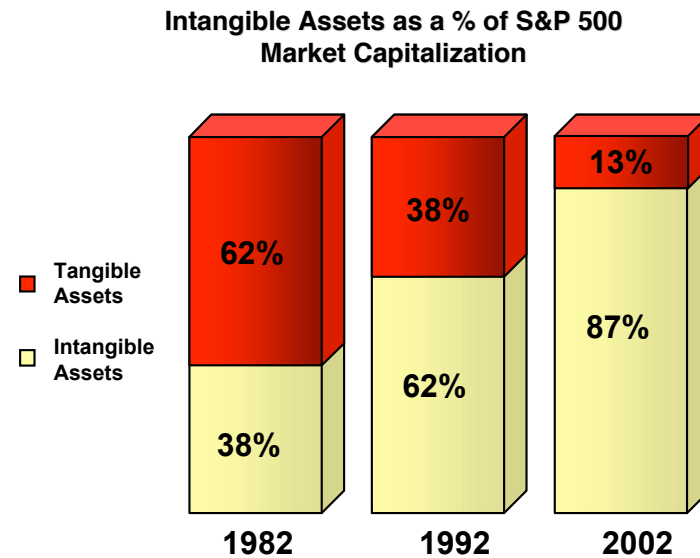
- Using IP to become a more attractive target for future merger or acquisition
- Setting up an IP acquisition
- Valuation of IP assets in a transaction

♣ Case studies

- InterTrust Technologies
- Rainfinity
- Gyration
- iPix

Overview

- ♣ Intellectual property (primarily patents, but also trade secrets, trademarks and copyrights, collectively “IP”) is increasingly important to the financial sector and the world economy
 - Pending: SCO Group suing IBM for alleged UNIX code trade secret violation
 - Oct 2004: Sun Microsystems paid Eastman Kodak \$92MM to settle JAVA patent dispute
 - August 2004: Yahoo settles litigation and licenses Overture patents to Google for approximately \$300MM in stock
 - Apr 2004: Microsoft paid InterTrust \$440MM to settle DRM patent infringement



Source: Brookings Institute

Unique Attributes of IP

- ♣ IP usually has a quantifiable value to operations (cost savings, price premium, market share)
- ♣ There may be direct and indirect applications for IP outside of the owner's core business
- ♣ IP tends to maintain value in distressed or turnaround situations
- ♣ IP can be strategically managed to expand its value over time
- ♣ The valuation and management of IP typically requires a high degree of subject matter expertise
- ♣ IP assets are generally intangible, divisible, and non-depletable

M&A Transactions of Pre/Early-revenue Tech Companies

- ♣ **Montgomery analyzed the valuations of pre/early-revenue companies to estimate the range of values for highly strategic IP-based acquisitions**
 - “Pre/Early-revenue” defined as companies with less than \$5MM in revenues at time of transaction announcement

Date Announced	Target Name	Target Business Description	Acquiror Name	Value of Transaction (\$mil)	Target Revenue LTM (\$mil)	LTM Revenue Multiple	
03/18/04	Vocaldata	Develops IP telephony solutions	Tekelec	27.9	4.8	5.8x	
07/23/03	uRoam Inc	Developer of web managed Linux software	F5 Networks	25.0	0.1	250.0x	
05/30/03	Cysive Inc	Dvlp web, wireless, voice software solutions	Snowbird holdings	74.5	2.9	25.7x	
05/19/03	Pressplay	Provider of online music services	Roxio	39.4	1.9	20.7x	
04/21/03	Listen.com	Provider of online music services	RealNetworks Inc	36.1	0.7	51.6x	
07/15/02	Campus Pipeline	Developer of education software	Systems & Computer Tech	42.0	5.0	8.4x	
05/22/02	PowerSmart	Manufacturer of semiconductors and batteries	Microchip	54.0	1.0	54.0x	
02/04/02	Vie Financial Group	Develop IT for e-commerce	OptiMark Innovations	30.0	2.2	13.6x	
				Mean	\$41.1	\$2.3	53.7x
				Median	\$37.8	\$2.1	23.2x

Source: Thomson SDC

Transaction values ranged between \$27.9MM to \$74.5MM, with a median value of \$37.8MM

Timing: Deciding When to Exit to Maximize Value

♣ Later stage vs. early stage exit

	Early-stage Exit	Late-stage Exit
PROS	<ul style="list-style-type: none">♣ First-movers have greater influence in defining market♣ May receive initial value boost for vision and promise♣ Potential acquirers may seek to make pre-emptive acquisition	<ul style="list-style-type: none">♣ Proven IP and business models will command highest firm value♣ Established market with foothold to penetrate peripheral markets♣ Growth strategy more easily definable♣ Better access to OEM channel
CONS	<ul style="list-style-type: none">♣ Unproven market receptivity♣ Business traction not yet established♣ High operating costs to fund R&D and S&M efforts♣ Inherent execution risk will prevent full realization of value	<ul style="list-style-type: none">♣ Increased competition♣ Alternative technologies may be developed♣ Policing IP rights in global market place may be expensive

Case Study: InterTrust

- ♣ Background
 - DRM software company
 - Public offering in 1999, secondary in 2000
 - Up to nearly 400 employees at the height
 - Filed the “Big Book” in 1995
- ♣ Unfavorable market conditions
 - Market for DRM software slow to develop
 - Microsoft likely to dominate market
- ♣ Board and management decision to reposition the Company as an IP licensing Company and position Company for sale
- ♣ Issues
 - Positioning a company to the public market
 - Selecting appropriate targets
 - Marketing the company
 - Due diligence
 - Structure
 - Execution

Case Study: InterTrust

- ♣ Positioning a company to the public market
 - IP roadshow
 - Claim charts for investors
 - “Value” of infringement
- ♣ Selecting appropriate targets
 - Technology targets
 - IP targets
- ♣ Marketing the company
 - Materials – tailored for each recipient
 - Vertical market focus
 - “infringement” analysis
 - Valuation
 - Traditional methods
 - Avoiding assumptions that are allegations of infringement
 - Tailoring valuation to specific vertical markets
 - Media DRM to Sony
 - Web services and trusted computing to Sun
 - Appropriate contacts
 - Corp Dev/M&A
 - IP
 - Due diligence

Case Study: InterTrust

♣ Due Diligence

- Cost
- Anticipation of issues
 - Validity
 - Leakage
 - Standards
 - Licenses
- Privilege

♣ Structure

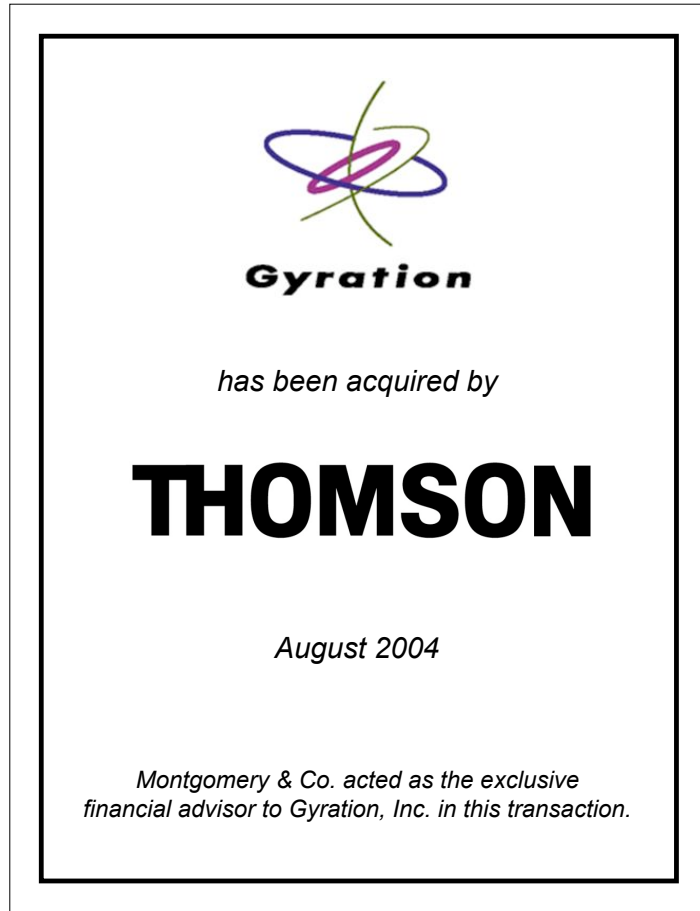
- Techniques to handle litigation in the target company
 - Litigation Trust
 - Insurance
- IP carve-out
- Transaction protection

♣ Execution

- Legal issues
- Banking issues

Case Study: Thomson / Gyration

Montgomery advised Gyration in the sale of its business to Thomson



- ♣ Gyration is a leading provider of gyroscopic sensor technology for consumer user interfaces
- ♣ The Company pioneered the use of gyroscopic sensors for “in-air” navigation of PCs and television remote controls, and was developing future applications in interactive video games, automobiles, etc.
- ♣ After 13 years of research and development, Gyration launched its product into a very nascent market and took on a difficult missionary effort to gain market understanding
- ♣ Within two years of launching its product, Gyration’s gyroscopic mouse and presentation remote technology penetrated more than 2,300 retail outlets and independently defined the “in-air” user-interface product category
- ♣ Limited capital forced Gyration to pursue a strategic sale, whereupon, Montgomery was engaged to evaluate market interest and determine the value of the IP
- ♣ Montgomery engaged in lengthy negotiations across nine months and several interested parties and secured the sale of the Company to Thomson SA, a French electronics and IP licensor

Case Study: Symantec / Rainfinity

Montgomery advised Rainfinity in the sale of a perpetual license to Symantec

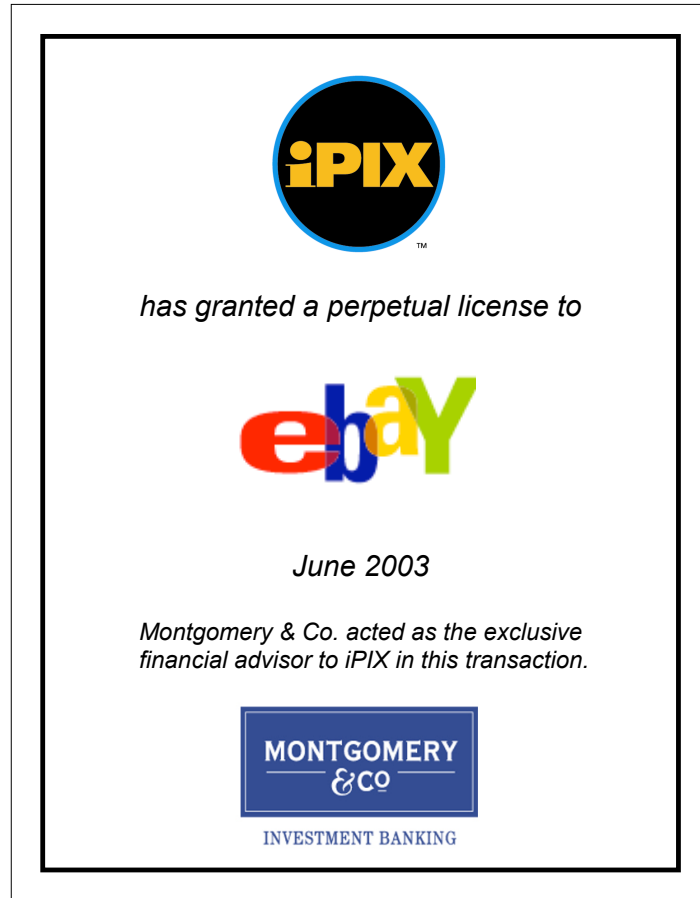


- ♣ Rainfinity, a leading provider of storage and security software solutions, wanted to sell its security business unit, RainWall and RainConnect, to focus on its successful storage franchise
- ♣ The proceeds from the sale of RainWall and RainConnect would provide the Company with growth capital for its storage business
- ♣ Rainfinity engaged Montgomery as its advisor because of the Firm's strong industry expertise in enterprise security and storage
- ♣ Montgomery contacted over 36 strategic buyers on behalf of Rainfinity and received mixed interest along with the probability of a lengthy process, which would effect the time to market of their storage product
- ♣ As a result, Montgomery recommended and negotiated the sale of a restricted, perpetual license to Symantec at an attractive value and excellent terms

- ♣ **Montgomery created a “win-win” situation:**
 - High valuation with attractive terms
 - New capital for Rainfinity to grow the storage business

Case Study: eBay / iPix

Montgomery & Co. advised iPIX in its license negotiations with eBay



- ♣ Internet Pictures Corporation (“iPIX”) was nearing the expiration of its agreement with eBay, which represented nearly 85% of total revenue. eBay stated its intention to develop its own solution and let the current agreement expire
- ♣ eBay initiated conversations with iPIX to buy a perpetual software license for a one-time payment as insurance for its new system. iPIX needed assistance in evaluating and negotiating the eBay proposal to maximize value
- ♣ Montgomery & Co. advised iPIX to explore a wide-range of opportunities with eBay as well as other parties. Leveraging its consulting background, Montgomery developed a two-prong approach: continue negotiations with eBay, while pursuing other commercial licensing and/or M&A transactions
- ♣ Ultimately, Montgomery was able to successfully execute a non-exclusive perpetual license agreement with eBay, whereby iPIX was relieved of certain liabilities and received cash to fund future business opportunities

- ♣ **Montgomery created a “win-win” situation:**
 - iPIX was relieved of liabilities and received cash to fund growth
 - Montgomery made valuable introductions to potential commercial customers
 - Montgomery and iPIX continue to work closely to explore opportunities to maximize value for iPIX shareholders

Things to Consider...

- ♣ Sale of IP assets or entire business ??
- ♣ Be prepared for intense diligence
- ♣ Assignability and licensing of IP

♣ Valuation Contexts – Transaction Based

- **M&A – Price Allocation, Exchange Ratio, Premium**
- **Technology Divestiture – Spin Out (Newco) vs. Spin-Off (sale)**
- **Joint Venture or Strategic Alliance – In-kind contribution value**
- **Venture Investment Decisions – Angels, VCs, Private Equity**
- **Patent Brokerage - Purchase/Sale of IP only (vs. technology)**
- **License Fees - Paid-up, Upfront payments & royalty rates**
- **Collateralization and securitization of IP**
- **Inter-Affiliate Transfers – Transfer pricing issues**

♣ Valuation Contexts - Non-Transactional

- Strategic IP Position Enhancement – IP Aggregation

Purchase vs. Exclusive License vs. Non-exclusive License

- Litigation –

Damages - greater of infringers profits or *reasonable royalty*

Settlement value

- R&D Investment – Make vs. buy decisions, Determination of IP-ROI
- Portfolio Management – Foreign filing and prosecution costs, Maintenance fees
- Charitable Donations – Tax benefit

♣ **Relative Importance of Intangible assets in Company Value**

S&P-500 Market to Book (M/B) Value Ratio - 1970's - 1:1; 2000 - 6:1 (83.3%)

Coopers & Lybrand ('97) - 2/3 of \$7 trillion market value of all public companies is attributable to intangible assets

Examples (2000 figures): Merck - 93.5%, Microsoft - 97.8%, Yahoo - 98.9%

Intangible Assets include:

Intellectual Capital - undocumented know-how, customer loyalty, management expertise, inter-company relationships, etc.

Intellectual Property - Legally enforceable rights in patents, copyrights, trademarks, trade secrets, mask works, databases, domain names, etc.

♣ Why are IP assets more difficult to value than tangible assets?

- **Historically, no public trading markets
(but this is changing, e.g., yet2com)**
- **Terms & Conditions vary widely.**
- **IP assets are inherently dissimilar**
- **IP transfers are often motivated by unique strategic considerations**
- **Details of IP transfers are usually not widely disseminated**

– Traditional Valuation Methodologies

- Cost (to replicate)
- Market (Comparables)
- Income (Discounted NPV of projected revenue stream)

IP-Specific Valuation Methodologies

- The Twenty Five Per Cent Rule
- Industry Standards
- Rating & Ranking
- Monte Carlo Analysis
- Real Options - Black Scholes

♣ ***So, what about the role of validity, scope and infringement analysis?***

Present quantitative valuation methods are essentially actuarial in nature:

i.e., they deal with individual patents, and patent portfolios, on a semi-statistical basis, approximating value based on comparison with past transactions involving similar patents, or using analogies to other kinds of intangible rights (e.g., stock options).

In the future, economists and patent lawyers will work together to create a valuation that better reflects the *exclusivity domain*, i.e., the market, defined by the patent claims...and takes into account the uncertainty factors inherent in all patents.

♣ Sources of patent uncertainty:

Validity - unknown prior art; obviousness, on-sale-bar issues

Scope - claims construction ultimately determined by Fed. Circuit

Infringement - doctrine of equivalents, design-around potential

Enforceability - inequitable conduct, laches, estoppel, etc.

***Note that these factors are ignored in litigation damages analysis, i.e., liability in terms of specific infringing product(s)/process(es) is assumed.**

♣ Take Away re Quantitative Valuation Methodologies:

The best that can be said about current methods of IP valuation is that they are *better than nothing* -

-- (but how much better is a matter of substantial disagreement).

“It is a sign of an educated mind not to expect more certainty from a subject than it can possibly provide.” (Aristotle)

“Valuation requires an intermediate perspective between ignorance and certainty, involving the exercise of skill, experience and judgment” (Razgatis)