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Coverage starts on page 46

FEATURE:
Private Equity
And Strategics
Make Nice
page 42

**PE's IP
King** 32

**Roger
Greville
Q&A** 72

THOMSON
★

Inside: A Ford Motor Buyout? Keep Dreaming, p38

PATENT MARKETPLACE PENDING: OCEAN TOMO AIMS TO BUILD AN ASSET CLASS

By Ken MacFadyen



James Malackowski

It is not everyday a new asset class is born. While intellectual property (IP) has been a key focus for American businesses since the signing of the Constitution, only now are people starting to look at it as an investment unto itself. Behind that charge is **Ocean Tomo**, a Chicago-based merchant bank that invests directly in the budding asset class.

In the U.S., many industrial businesses have abandoned their manufacturing roots and embraced new roles almost solely as designers or architects. The value of a typical company rests less in the factories and warehouses, and more in the catalogues of patents and trade secrets.

According to Ocean Tomo's founder, **James Malackowski**, intangible assets such as trade secrets, patents and copyrights made up a mere 17% of the market value of the S&P 500 in 1975. Last year, that number hit 80 percent.

"With manufacturing going to China and services being outsourced to India, what's left? Intellectual property," he says.

The way Malackowski tells it, the view of intellectual property has changed drastically over the past 30-plus years. He describes the 1970's as being in a state of chaos as it relates to IP rights, with "var-

ious courts holding differing views." For that reason, there was no way to truly value a patent's worth.

Following new regulations and the establishment of a separate court of appeals to handle all patent matters, the enforcement of intellectual property rights became more predictable. This led to the era Malackowski calls the "period of the futile lords," when "the only people who cared [about IP] were the large patent owners."

Today, Malackowski believes the U.S. is in the midst of its third stage, an era in which the value of IP can now be "separate and distinct" from a particular product. "Value is intangible today. It's a reverse from twenty years ago," he says.

This new view, in turn, is creating a line of investors that see IP as an asset class in and of itself.

Investments in the space can take on many forms. There are the controversial patent trolls, or patent licensing and enforcement companies (P-LECs) as Malackowski calls them, which accumulate patents with the sole purpose of squeezing licensing fees from companies infringing on the designs. Then there are the venture leaning groups that will buy patents with the intention of commercializing an acquired blueprint.

Ocean Tomo, for its part, takes a number of different approaches. Its mezzanine fund, however, adheres to a private

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The IP Litigation Frenzy

The buzz surrounding the IP marketplace today typically revolves around litigation issues. When the IP rights of Research in Motion were called into question by patent warehousing company NTP, three million businessmen and women lived in fear that their Blackberry service would be brought to an abrupt halt. As it turned out the Canadian based tech firm reached a \$612 million settlement with NTP, putting to rest any such fears.

While the Blackberry case has been among the most notable patent squabbles in recent months, it is by no means an isolated situation. Hewlett Packard recently sued G&G Ninestar Image Co. of China, claiming that the ink cartridge manufacturer had infringed on its patents; Blockbuster Video is currently being targeted by Netflix, which says the video giant is violating its patents; Symantec is suing Microsoft, saying it infringed on certain data storage technology; and Apple Computer has agreed to pay Creative Technology a \$100 million licensing fee that will end a patent suit that involved Apple's iPod.

And these are just the cases making headlines in the last week of August.

While the legal tussles might make the industry appear somewhat unhinged, **James Malackowski** counters that the suits actually represent

the IP space's growing stability.

"The enforcement process is a lot better today than it was 20 years ago. Because of that you have a lot more value associated with IP," he says. And with more value being ascribed to the space, the natural consequence is more head-butting among groups trying to profit on that value.

A lot of criticism has been heaped on the so called patent trolls—firms such as NTP that accumulate patents simply to litigate licensing fees or settlements out of companies in violation of existing patents. Ocean Tomo refers to these entities as patent licensing and enforcement companies, or P-LECs, and while the firm doesn't participate in this kind of investment strategy itself, it does view their presence as necessary to the IP industry's development.

Keith Cardoza, who declined to pick a side in the Blackberry case, did tell *Buyouts*, "The people who own the patents should be viewed in the marketplace as the legitimate owner of the [corresponding] technology."

Eventually, Ocean Tomo anticipates that the battles for IP rights will shift from the legal domain to the financial domain. And from there, the firm expects the IP marketplace to blossom into its own asset class. "Whether you like it or not, it's here to stay," Malackowski says. ❖

equity model. The firm, with backing from Texas billionaire and former Reform Party presidential candidate **H. Ross Perot**, operates a \$200 million mezzanine fund, designed specifically to invest in companies that "own valuable patents or IP," according to **Keith Cardoza**, a managing director at the firm who runs Ocean Tomo's investment activities.

"The fund is really looking at compa-

nies that are cash flow positive, but need \$5 million to \$25 million to make an acquisition or recapitalize," Cardoza explains. "We'll take a first lien position and use the patents as collateral on the loan... Most traditional financial institutions will ignore the value of intellectual property."

Mezzanine is just a start for the firm. By the end of the year, Malackowski anticipates the firm will control two

mezzanine funds, a UIT (unit investment trust), an index product for the public markets and two hedge funds. Additionally, as a merchant bank, Ocean Tomo continues to expand its service offerings. The firm is a go-to source for IP valuations, provides traditional M&A advisory services as well as specialized services for distressed situations, and can be engaged for expert and litigation support—a key area for the firm considering all courtroom activity surrounding the IP space (see box left).

Value Finders

Almost everything Ocean Tomo does revolves around determining value for intellectual property. The firm's roots go back to 1988, when Malackowski, working for consulting firm Peterson & Co., was approached by a client that needed to determine how much a particular patent was worth. He hit up all of the major accounting firms (then eight), coming up empty handed each time. Seeing an obvious need in the market, Malackowski launched **IPC Group**, a firm whose sole focus was in valuing IP.

While IPC Group came some 15 years before Ocean Tomo's launch in 2003, the expertise the firm helped develop in patent valuation standards set the foundation for Ocean Tomo's strategy today.

"There are three schools of thought. You've got the market approach, the cost approach and the income approach," Malackowski explains, describing how the firm puts a value on a patent. "The market approach looks at what similar assets trade for, the cost approach accounts for what it cost in terms of R&D to develop and protect the design, and the income approach incorporates the net present value of expected royalties."

While it sounds cut and dry, there are some obvious intricacies involved. A strong IP portfolio generally consists of technologies that are in use today. That makes assessing patents and copy-

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rights easier, and therefore places a premium on applied technologies. Where it gets tricky is when the intellectual property in question is only based in theory.

“There are a lot of great ideas collecting dust on shelves that wouldn’t be worth that much,” Malackowski says, citing Sony’s Betamax video recorder technology as a classic example.

“that don’t even know they have,” Malackowski says.

“One of the parameters we’ve set is we won’t invest in a business unless we’re a principal in the deal. From there we help them to develop and grow their IP portfolio and facilitate their business strategy to help them develop the [IP] assets that are separate from their core business,” he adds.

While Ocean Tomo will invest its mezzanine fund alongside a buyout, the firm has yet to back any LBOs. That said, according to Cardoza, many private equity firms have begun to recognize the value of IP.

When **Bain Capital**, **The Carlyle Group** and **Thomas H. Lee Partners** acquired Dunkin’ Donuts, for instance, the buyers linked their asset-backed debt to a securitization of the doughnut and coffee chain’s intellectual property. While Ocean Tomo did not work on that deal, the firm in May helped KCD IP secure a similar \$1.8 billion ABS financing tied to its trademark royalties and related rights. KCD is a products and services business.

“Most buyout groups have a legacy history in investment banking as opposed to operations or entrepreneurial endeavors. The context in which patents and copyrights are used everyday may not be something that they’re overly familiar with, but more and more we’ve seen a growing interest,” Cardoza says.

As the light bulb goes off and investors begin to fully understand the value of intellectual property, Ocean Tomo sees the industry becoming a regular destination for institutional investors, perhaps someday rivaling private equity for allocations. And when IP as an investment strategy stretches beyond its niche status, Ocean Tomo expects to be positioned to capitalize.

It should also be noted that like any good inventor, Malackowski has patents pending in the field of IP business method and IP financing. ❖

// You can have a patent that looks great, but because of a few key words it becomes essentially worthless. It can be as simple as transposing the word ‘comprising’ with the word ‘consisting,’ and that changes the entire value. //

—James Malackowski

In describing what makes for a weak IP portfolio, he cites that seemingly insignificant factors can make all the difference. “You can have a patent that looks great, but because of a few key words it becomes essentially worthless. It can be as simple as transposing the word ‘comprising’ with the word ‘consisting,’ and that changes the entire value.”

A Patented Approach

When Ocean Tomo makes an investment, the goal is always to get the recipient to recognize what they have for intellectual property. While companies such as Microsoft, IBM and Procter & Gamble are themselves experts at exploiting their IP assets, there is another set of businesses

Cardoza notes that while companies may realize that innovation and technology result in a competitive advantage, many businesses don’t have the toolset to make an accurate assessment as to how valuable or meaningful their patents can be. This partially stems from the long-standing belief that IP assets don’t translate directly to the bottom line.

Part of the challenge for Ocean Tomo is to change that way of thinking. Cardoza explains, “The accounting systems in place have not adopted to the knowledge economy we’re now in. When a company invents something it’s booked as a research and development expense [as opposed to the addition of a new asset].”