Where is the Value in Intellectual Property?

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Whether a company is a start-up or a large enterprise, there are a few basic truisms in running a successful business. Controlling costs and recognizing returns on investments are high on that list. Running a business, be it large or small, is a balance of risks and rewards. Ideally, the rewards outweigh the risk.

These axioms also ring true for intellectual property (IP) protection, and they bring up some seemingly universal questions from clients. "What exactly is my IP?" "How can I protect it?" "Is it worth protecting IP?" Let's focus a bit on that last question and explore whether it is worth it to protect IP.

Why Protecting IP Makes Sense

When an enterprise conducts new research and development, or when a company's launch is based on an innovation, IP is almost always a topic of conversation. It is important to identify that which can be protected and develop a strategy for how to protect it. Neither of those topics is trivial and I do not want to imply in any sense they should be shortchanged. But assuming that an innovation exists, it is identifiable, and a sound strategy can be developed to protect that innovation, the next logical question is, "Is it worth protecting?"

The answer is no one really knows. In most cases the entrepreneur, program manager, division lead, or CEO makes what we used to call in the Air Force, a SWAG—a Scientific Wild-Ass Guess. Those guesses can be sophisticated and use market analysis and various data analytics to minimize the risk. Even so, there remains an element of risk. And this is where stakeholders must address the question: "Is the IP really worth protecting?"

We all recognize that some IP is incredibly valuable and that most IP is not. But lost in that simple comparison is the reasoning behind, and thus the value in, IP protection.

It will come as no surprise that companies that produce products are more highly valued (have a higher marketable net worth) than companies whose primary revenue source is a service. The logic to this conclusion is very straightforward. A product that is successful will likely remain successful until it is replaced by a different and better product. In theory, if the product is in demand, cash flow from sales can continue indefinitely while cost of goods sold can decrease over the life span of the product. For a service, the cash flow ends with the termination of the service or service contract.

Company valuation is recognized by the market in term of multiples. For example, a product company selling $1M worth of products a year may be valued at $5M, making its multiple 5. The market considers that sales are likely to continue and gives the company credit for filling a recognized consumer need. Conversely, a service company making $1M by providing services in the time period may only be valued at 800K, making its multiple 0.8. As companies strive to obtain higher valuation, it is easy to see why they endeavor to come up with new innovations and products, and to tie their revenue to those products. The more the multiple grows, the harder it is for a competitor to displace that product from the market. And that is where IP factors into the valuation of a company.

IP and the Valuation Equation

IP helps a company establish and maintain a competitive advantage. Let's break that down. To achieve those high multiples, a company needs to have contracts to sell its products. What is it that entices others to engage with the manufacturer to sell their products and not a competitor's product? There are numerous factors that go into these types of contracts, but one significant aspect is IP rights.

A manufacturer that has the right, and the only right, to manufacture, sell, and distribute a product has a significant advantage at the bargaining table. Having protected an innovation by establishing IP rights enables the company to create a product-based cash flow and threaten the margins of those who wish to sidetrack those rights.

Without that protection and those IP rights, gaining an agreement by which a company is the sole provider of a product becomes challenging or, at best, a level playing field on which the company can provide the reseller with the highest margins. The value of IP protection is, therefore, more than the ability to sue an infringer. It is the leverage to craft an environment in which the worth of an innovation can be recognized.

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