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## The Trouble With Intellectual Property

**Investing in technology often means more than just evaluating the business and determining whether the price is attractive -- a lot of technology companies depend on their intellectual property (IP) for continued business success. The defensibility of these assets is critical to your investment, and every investor should understand the risks of investing in IP.**

By Zeke Ashton
July 23, 2001

Intellectual property, or "IP" companies, as they are called in investor jargon, are not new. In fact, one can argue that virtually every successful technology company is in some way an IP company: What is Microsoft, after all, but a company built on intellectual assets? Nevertheless, in the past decade, intellectual property has become a more highly recognized component of economic value, to the point that we are seeing companies concentrate on creating intellectual assets to the virtual exclusion of all else -- the so-called "pure IP" company. This move to an intellectual property-centric world has some very big and potentially dangerous implications for investors, particularly Rule Breaker investors.

You see, investing in rule-breaking technology stocks today involves more than evaluating the fundamentals of a company's business and determining whether or not it's selling at an attractive price or offers 10X/5Y (a tenfold increase in value over five years) potential. In cases where intellectual property represents a material portion of the company's intrinsic value, the defensibility of such assets is playing a greater role than ever in determining success or failure.

If you're an investor in companies like **Rambus** (Nasdaq: RMBS), **Qualcomm** (Nasdaq: QCOM), or **Cree** (Nasdaq: CREE), you probably have some awareness that the market caps of these companies depend in large part upon the ability to defend (and monetize) patents. But the same holds true for most biotechnology or drug companies. In short, if you are investing in technology, you need to be aware of the new playing field.

There have been two recent intellectual property battles that I view as warning shots for investors, and both involved huge stakes. First, there was the patent infringement battle between **Amgen** (Nasdaq: AMGN) and **Transkaryotic Therapies** (Nasdaq: TKTX), with Amgen's $3 billion dollar blockbuster drug Epogen threatened by Transkaryotic's gene-activated version of the same compound. Amgen sued Transkaryotic for patent infringement. Investors on both sides were suddenly confronted with the challenge of determining how defensible Amgen's intellectual property would be. As it turned out, Amgen's patent defenses were enough -- Transkaryotic investors saw their stock lose a third of its value on January 19, the day of the ruling, and it continued to slide almost 60% within the next two months.



Then there was Rambus, the innovative computer memory technology company whose plan to hold the estimated $30 billion DRAM industry at gunpoint with a massive portfolio of patents blew up when a judge determined the company's patents on SDRAM were not infringed upon by semiconductor manufacturer **Infineon Technologies** (NYSE: IFX). That blowup served as my canary in the coal mine, the warning shot that challenged what I previously believed about technology investing. I had a small amount of money invested in Rambus. I was very aware that the company's value rested on its intellectual property and the defensibility of those assets. And I still got burned. Why? Because I was wrong in my determination of how defensible Rambus' IP would turn out to be.

First, there were the patents -- Rambus had more than 100 patents covering its inventions. There was also some real evidence that those patents were watertight -- the fact that seven of the world's top-10 DRAM makers had signed deals agreeing to pay Rambus a cut of their sales. Think about that for a minute: Computer hardware margins are wafer-thin, and you'd think that huge memory makers would certainly investigate the patents and make real sure that Rambus had a bulletproof case before agreeing to fork over a royalty that could amount to big numbers, right? I certainly thought so. Infineon didn't agree, and forced Rambus to defend those patents in court.

You probably know the rest of the story. In early May, a federal court in Virginia not only ruled that the Rambus patents were not infringed upon, but also found that Rambus had committed fraud in its dealings with an industry group that was working on developing common standards for the memory industry in the early '90s, and ordered Rambus to pay $3.5 million in punitive damages (later reduced to $350,000). Rambus stock fell from the low $40s in March and drifted lower as news leaked out that the trial was not going its way. (Rambus' stock is under $10 as of this writing, a loss of more than 75% of its value.)

The bath I took with my Rambus investment awakened me to the danger of IP. The nature of patent or other intellectual property litigation is virtually impossible to predict, and can pull in peripheral information, such as the alleged fraudulent activity in the Rambus case, that even the most research-oriented investor would likely never have uncovered and is not disclosed in regulatory filings or other information typically available to the public.

Risks don't stop at the defensibility of the intellectual property, either: There are risks of surprise damage awards, legal settlements, and high litigation fees that can negatively impact a company's earnings. More importantly, unless you specialize in this area, you'll be playing against a lot of smart players who do -- and it's never a good idea to sit down at a card game you've never played with a table full of professional card sharks.

The serious Wall Street folks can afford to pay a legal consultant or patent specialist ten gees to research the legal aspects. In fact, if they have even a $1 million investment, it's not even a material cost to them to do it relative to the size of the investment. Can you compete with that? There are many areas where individual investors have an edge on Wall Street -- but this probably isn't one of them.

Then there is the patent process itself. The United States Patent Office is flooded with new patents, and there simply isn't enough manpower and time to make a complete check for prior art patents. It's a fair bet that companies will increasingly have to take their fights to court to sort out the mess -- meaning more uncertainty as to the value and defensibility of patents. In the biotechnology industry, for example, the hard-fought, high-stakes patent battles will become more the norm than the exception, and if you want to invest in that area, you need to be prepared for this.

One resource I can recommend to technology investors who want to learn more about intellectual property risks is a special investor report from M-Cam, a company that specializes in intellectual property management. I also recommend that you register for their free newsletter, "Patently Obvious." Past issues featured patent analyses of Amgen, Rambus, Qualcomm, and **Symantec** (Nasdaq: SYMC). If you see a company you own featured in one of these reports, it's probably worth paying attention to.

As a final word on intellectual property companies and patent issues, here's a checklist of questions to ask yourself:

- Is the patent in a legal dispute really material to a company's value? For example, **Amazon's** (Nasdaq: AMZN) patent on one-click purchases isn't crucial to Amazon's intrinsic value; rather, it's Amazon's brand and 30 million customers that will determine Amazon's economic value. In the case of Rambus, however, the patents in question constitute a large portion of the company's ability to create economic value.

- Does the company hold a substantial patent position that has been successfully defended in previous court cases? Has the company been successful at extracting royalties and license payments from other companies?

- Do I understand what is at issue and how much a negative outcome in court could cost me in terms of long-term investment value?

If it's difficult for you to evaluate how much a negative patent litigation outcome could damage your investment, then demanding a lower price to provide yourself a margin of safety is probably the best way to protect yourself. Of course, if you really can't answer any of the three questions above, it might be best to steer clear and find an alternative investment in a sector or industry that you know better. After all, if you're going to play, it's best to have the home field advantage.

*Zeke Ashton is currently awaiting the resolution of a patent battle involving his favorite company, Andrx Pharmaceuticals, and wondering whether he should have become a patent lawyer. Zeke does not own any of the companies mentioned in this article. The Motley Fool is investors writing for investors.*

Rule Breaker Portfolio

7/23/01 as of ~8:30:00 PM EDT

| Ticker | Company | Price Change | Daily Price % Change | Price |
|---|---|---|---|---|
| **AFFX** | AFFYMETRIX INC | (0.53) | (2.72%) | 18.95 |
| **AMGN** | AMGEN INC | (2.12) | (3.49%) | 58.59 |
| **AMZN** | AMAZON.COM | (0.95) | (5.59%) | 16.03 |
| **AOL** | AOL TIME WARNER INC | (1.31) | (2.96%) | 43.00 |
| **CRA** | APPLERA CORP - CELERA GENOMICS | (1.09) | (3.43%) | 30.71 |
| **EBAY** | EBAY INC | (1.84) | (2.75%) | 64.96 |
| **HGSI** | HUMAN GENOME SCIENCES | (2.42) | (4.80%) | 47.98 |
| **SBUX** | STARBUCKS CORP | (0.57) | (2.81%) | 19.68 |

**Overall Return -- total % Gained (Lost)**

| | Day | Week | Month | Year To Date | Since Inception (8/5/1994) | Annualized |
|---|---|---|---|---|---|---|
| Rule Breaker | (3.14%) | (3.14%) | (12.75%) | 11.70% | 418.69% | 26.65% |
| S&P 500 | (1.64%) | (1.64%) | (2.72%) | (9.79%) | 159.82% | 14.69% |
| S&P 500 (DA) | (1.55%) | (1.55%) | (2.59%) | (9.33%) | 174.08% | 15.57% |
| NASDAQ | (2.01%) | (2.01%) | (7.96%) | (19.51%) | 176.12% | 15.69% |

Our overall return stats understate the portfolio's actual returns; here's why. See the internal rate of return below for an accurate statement of our annualized returns.

**Internal Rate of Return -- Annualized Rate of % Gained (Lost)**

| | Since Inception (8/5/1994) |
|---|---|
| Rule Breaker | 31.54% |
| vs. S&P 500 | 13.85% |

| Trade Date | # Shares | Ticker | Cost/Share | Price | Total % Ret * |
|---|---|---|---|---|---|
| 8/5/94 | 4020 | AOL | 0.45 | 43.00 | 4955.86% |
| 9/9/97 | 1320 | AMZN | 3.18 | 16.03 | 509.45% |
| 12/16/98 | 1160 | AMGN | 21.44 | 58.59 | 173.22% |
| 7/2/98 | 940 | SBUX | 13.98 | 19.68 | 40.80% |
| 2/26/99 | 1145 | EBAY | 46.55 | 64.96 | 39.56% |
| 6/21/01 | (1150) | AFFX | 21.60 | 18.95 | 12.28% |
| 12/17/99 | 1260 | CRA | 39.76 | 30.71 | (22.75%) |
| 9/22/00 | 560 | HGSI | 80.05 | 47.98 | (40.07%) |

| Trade Date | # Shares | Ticker | Total Cost | Current Value | Total Gain * |
|---|---|---|---|---|---|
| 8/5/94 | 4020 | AOL | $1,816.44 | $172,860.00 | $243,636.00 |
| 9/9/97 | 1320 | AMZN | $4,204.20 | $21,159.60 | $56,466.50 |
| 12/16/98 | 1160 | AMGN | $24,875.50 | $67,964.40 | $43,088.90 |
| 2/26/99 | 1145 | EBAY | $53,294.44 | $74,379.20 | $21,084.76 |
| 7/2/98 | 940 | SBUX | $13,138.62 | $18,499.20 | $5,360.58 |
| 6/21/01 | (1150) | AFFX | ($24,843.50) | ($21,792.50) | $3,051.00 |
| 12/17/99 | 1260 | CRA | $50,093.00 | $38,694.60 | ($11,398.40) |
| 9/22/00 | 560 | HGSI | $44,830.50 | $26,868.80 | ($17,961.70) |
| | | | Cash: $24,861.92<br>Total: $423,495.22 | | |

* Our long term totals include both our realized and unrealized gains. For instance, we have sold portions of AOL and Amazon in the past, and those realized gains are included in our total returns for these stocks.

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**Note**
The Fool Portfolio was launched on August 5, 1994, with $50,000. It was renamed the Rule Breaker Portfolio in October 1998. The investing strategy began with the first investments of the Fool Port and has evolved with time and experience. In July 2001, the portfolio began adding $12,500 each quarter (We missed Jan. 2002, so we added $25,000 in April 2002). We skip a quarter if we have enough uninvested cash or cash available in stocks we would prefer to sell to make new investments. All transactions are shared and explained publicly before being made, and returns are compared in each week's column to the S&P 500 (including dividends where noted) and the Nasdaq composite. For a history of all transactions, please click here.

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