Ironman Inventing

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Intellectual Property Business Strategies For The Independent and Small Business Innovator (Part III)

Naturally, the fundamental drive of any innovator to invent, create and protect intellectual property is the future potential of making money from it. (Although there are those altruistic environmentalist-types who will invent just because it may benefit someone's grandkids, this series is meant to assist true-blue capitalists in maximizing the value of their creations).

Although every "deal" differs from another, it is nevertheless fruitful for you to understand *how* the value is calculated on intellectual property, and *how and when* -- and *if* -- you can realize the cash value of your ideas.

Part III takes you through a few methods that have served me well over the years. I encourage you to find other calculation methods for comparison, ease of understanding or ease of implementing. Everyone has their own "best way" based on their own experiences.

There are two sides of the innovation commercialization process -- Costs and Sales. Obviously, value (if it is a positive number) is the difference, i.e., Sales price minus Costs. This delta difference is essentially your *Intellectual Property Value*, although there could be a number of lesser factors built into the price.

This is the number you want to be the highest possible. It is also the number your "buyer" wants to be as low as possible. This is where a good negotiator is worth his weight, maybe literally, in gold.

- Costs will consist of all investment you have made in engineering, tooling, prototypes, patent and trademark fees, and all associated miscellaneous expenses incurred to get your idea to a stage where it can be sold, licensed or otherwise converted into cash.

- Sales, for our purposes here, is defined as sales of your tangible creation (i.e., art, music, products), the sale or licensing of your intellectual property rights (i.e., license a patent, sell rights to a song), or the sale of the company which owns the rights to the intellectual property (i.e., you sell the stock which you own in your company at a price higher than what you bought it for which is largely as a result of the added value of your intellectual property).

The various accounting methods of arriving at a "valuation" of intellectual property can be daunting. When big dollars are at stake, leave this exercise to a CPA, investment banker or other professional -- but make sure you understand what they are doing with the numbers.

Also, don't assume that the simplified outline I am presenting here is all you need to "do-it-yourself" if you are not experienced in this area. Have an accountant or professional take a look at the "deal" before you sign any sales or licensing agreements. Because of the limited time and space in this feature, we'll cut to the essentials.

The following addresses the three different strategies introduced in Part I. They are: <

- the Sale or License of Your Intellectual Property
- the Sale of the Tangible Goods or Products that are protected by your patents & trademarks,
- the Sale of the Stock in Your Company which produces the products protected by your patents and trademarks.

The Sale or License of Your Intellectual Property

(Note: Patents are used for purposes of presentation, but trademarks and copyrights generally and similarly apply.)

This is probably the "easiest" method of obtaining cash from your idea. I say easiest because this method -- which involves first obtaining a patent or trademark, then licensing the production rights to a manufacturer or distributor who can bring the products to market -- requires the innovator to develop the idea to the lowest level needed to demonstrate to a potential buyers.

A crude working prototype is usually all that is necessary, as far as product development goes. But the "Sale or License" strategy is also the method which accounts for the smallest number of ideas to make it to the commercialization stage.

Too many inventors or innovators think they have the "million dollar winner" -- but unfortunately the buyer or licensee too often thinks otherwise. The following will help you to understand how the potential buyer calculates the value of your idea. Once you have this lesson under your belt, you can present your idea with all of the necessary "value points" addressed -- even before the buyer does the analysis themselves.

Understand the cost of getting into the "business". The laundry list below outlines the check points a potential buyer will look at. Unless you have a good handle on these costs early in the game, you will have no idea whether your idea has a chance of being economically brought to market.

- Is there a patent issued or pending?
- How much engineering has been completed at what cost?
- How much engineering has yet to be done? (Don't forget about Underwriters Labs testing if required, engineering for different sizes or configurations if the product is a "family" such as a line of different sized shoes, destructive testing or testing to failure, CAD drawing development, finite element analysis to assess structural integrity, development of exotic materials or formula blends, etc.)
- What is the probability that the product cannot be made as designed?
- *Who* will provide the additional engineering effort?
- How much assembly labor will be required to produce the product?
- What is the total cost of production (all parts, labor and fixed overhead)?
- What is the estimated retail price?
- Is this number at least 4-1/2 times the cost of production? If not, there will be price resistance.
- Will expensive tooling such as plastic injection molds be required?
- How much will it cost the buyer to advertise and market the product? Does this product fit into an existing product line where the buyer can inexpensively add it to their marketing and sales effort?
- Who are the competitors? (Don't be fooled into thinking that there is "no competition" -- bologna! I have not yet seen a product without competition. If there is no competitive "product", there will always be competitive "alternatives" -- as well as the alternative to spend money on a movie or other personal item. Your pricing, features and benefits must be compelling so that a consumer will part with their money.)

This is a short list. A more comprehensive list (along with industry typical prices) can be found in my Ironman Inventing books and in various articles printed from time to time in the Inventor's Digest magazine.

Suffice to say, your equation should look something like this, although your numbers should reflect your actual situation:

Buyer's costs:

Total production tooling cost -- $100,000

Additional Engineering Req'd -- $50,000

Packaging Design & Prod -- $35,000

Additional Legal Fees -- $11,000

Total Buyer's Direct Cost -- $196,000

Buyer's Estimate of Unit Sales/Year -- 250,000 units

Buyer's Estimate of Revenue/Year -- $1,500,000
(This means buyer's cost of production is $333,333 -- max.)

Buyer's Gross Profit from Sales (@ 25% of revenue) -- $375,000 per year.
(Note: 25% is *high* in most industries.)

Estimated Life of Product before redesign -- 2 years
(Your's may be different -- know your product & market)

Less Amortized cost (the $196,000 above / 2 years) -- $97,500) per year

Gross Profit -- $375,000

Amort Cost -- $97,500

Adjusted profit/yr -- $277,500 on $1.5 million in sales

Total profit over life of product ($277,500 x 2) -- $555,000 on $3 million in sales over two years.

Estimated worst-case profit projections (20% less) -- $444,000

Percent profit @ worst case -- 14.8%

Lowest acceptable company profit on a product line -- 10%

Difference between lowest acceptable profit & worst case profit ($444,000 - $300,000) -- $144,000

If the total "spread" between the lowest acceptable profit and worst case sales scenario for two years of operation is $144,000, the *maximum* you should expect to receive over the two year licensing agreement would be a total of $144,000. This is the *maximum value* of your idea to this particular manufacturer over a two year period.

Recognize that a buyer will put every expense they can think of into the formula to artificially reduce the profit as low as possible. You, on the other hand, must research the market, prove that a higher sales price is acceptable, show a projection of 350,000 units per year sales instead of 250,000 units (and back it up with market data), and know the competitors cold.

Only by doing your homework can you begin to test your research against the potential buyer's internally developed numbers. You can get a head start by generally using the percentage figures I've outlined above. You will have to get accurate costs put together, though, if you are to be a credible presenter.

For more general recommendations on how to license your inventions refer to *The Inventor's Desktop Companion* by Richard Levy. Richard has licensed more than 80 products, including the popular game, Adverteasing.

Being able to show the potential buyer a higher "spread" is your primary method of increasing potential value in a patent licensing opportunity.

The Sale of The Products

By selling your products yourself, you could possibly earn the profits shown in the above scenario yourself. Compare the reasonable two year profit of $555,000 (or 25% of the $3,000,000 sales) to your $144,000 royalty. Before you say, "I'll take the $1/2 million over $144,000 any day", understand that there is a reason you will get "paid" the additional $411,000. You will have to work for it -- and at high risk.

Some experts say that the licensing of a patent is lower risk than trying to sell a product. I agree that you will probably lose less if the product flops, but I contend that a higher number of products get sold if the inventor takes the product to market themselves than the number of products which are successfully licensed. If your patent does not attract a licensee, no matter how little you have risked -- it's all gone.

Somehow, when you produce your own product, you find creative ways to keep the "business" alive. And since you have inventory, there is always an intrinsic value to your patent and product, even if it is to a discount wholesaler who will pay you a nominal fee.

I feel that the "higher risk" of bringing the product to market yourself refers to "more money at risk", and that the "lower risk" option of licensing simply means you could lose less. However, I feel that the *probability* of success is increased in the "sell the products yourself" strategy.

This sentiment is echoed in the *Stand Alone, Inventor!* book by Robert Merrick. Merrick Industries manufactures and sells a variety of products covered by Bob's patents.

I know "it takes money to make money" -- and you can't afford the patent attorney, let alone the tooling. Well, you can use other people's money (OPM). But before you approach a partner you hope will help come up with the required investment, you will still have to work through every number we went through in the first scenario.

Just because you have someone coming "in on the deal" with you does not mean you can slack off on the market research, competitive analysis or profitability calculations. To the contrary, you will have to be even more diligent since you have "Other People" who have a stake in your projections. But those other people will be the ones who will help you make the numbers as accurate as possible -- two heads are better than one.

Here are a few suggestions.

If you are a good salesperson, understand the market for your product, and feel you can get your product accepted throughout the distribution channel, you may need a production partner. There are a number of manufacturers who you can partner with.

Many plastic molders will pay for the tooling and inventory (assuming you can sell the product), for a piece of that $1/2 million dollars you calculated as potential profit. Maybe a 50/50 split? 60/40? It's all up to negotiation, and mutual agreement of the relative strengths each party brings to the table. If you are a buyer for Taco Bell, and invent a new biodegradable plastic coffee cup, you have a leg up on the contractor-turned-inventor who got burned by coffee at a drive through window. The cup molder will probably take a smaller percentage since you know the ropes in getting a new cup design through the purchasing channels.

Good places to look for manufacturers interested in picking up an interest in a (plastic) product which they can produce include *Modern Plastics* and other plastics trade magazines. You can find the addresses of these magazines at your local library in *Gales Directory of Publications*, or through Gale Online.

In the back of these industry publications, there is usually a classified section listing "manufacturing capacity available". These are the manufacturers that obviously have capacity, and that may consider building your product. You can also take a look in the *Wall Street Journal* classified section which occasionally will have manufacturers (domestic and off-shore) under a similar heading.

Finally, many local inventors associations have developed relationships with manufacturers over the years who have had successful experiences in working with inventors. Get a letter off to the ones nearest to you, since you will want to work with a manufacturer you can easily visit.

If you are technically competent, but can't sell, consider adding a distributor or manufacturer's sales rep to your "team". Do this *before* contacting a manufacturer because it will be important to show the manufacturer that you have the capability to *Sell.* Decide the split with the sales-partner before sitting down at the bargaining table with the molder and you will increase your chances of striking an acceptable deal.

Briefly put, your value in building and selling your own product is the profit you (and your hand-selected team players) will receive from the sale of each and every product.

The third strategy takes the concept one step further. It assumes that you and your hand-selected team members are such a good, dynamic and successful group that you want to build a company just to produce and sell the products. Not only will you receive the value related to the "profit", but your company will begin to build another layer of profit potential -- that of capital stock appreciation.

The Sale Of Stock In Your Company

We've all heard the wonderful "Richest Man In The World" stories about Bill Gates. Well, he certainly has mastered this third method of increasing personal value of intellectual property through the building of a company around a proprietary product. Although there are myriad strategic business events and decisions which have propelled Microsoft beyond the realm of the "common" inventor, the fundamentals of realizing the increased value remain the same.

I'll try to keep it simple, but if you get confused, ask a stock broker for an explanation of "Price to Earnings" ratio (P/E) and balance sheet assets. Also, although it's been some time, I think the *Wall Street Journal* still has a "Stock Market Primer" available by itself, or with a subscription. Getting familiar with the stock market and industry P/E ratios will help you develop perspective on how you can profit by owning "your own company".

Here is the concept:

First you follow the market research and business opportunity verification steps outlined in the first strategy.

Next, you develop a plan to produce and sell your products as outlined in the second strategy.

Finally, you develop a business plan, form a legal structure (usually a corporation), and put up the minimum investment necessary to begin business operations. There are business advantages to incorporating (as opposed to simply producing and selling the products as outlined in strategy #2) include the ability to obtain product liability insurance, etc. You can review various business startup books for more information on business formation.

What is important is to know that the value of the intellectual property -- if that is the basis for the products produced -- is greatly increased by means of wrapping it with a successful company.

The following is intended to introduce you to an overview of the valuation process by walking you through a hypothetical scenario. The process is complicated, and is best addressed by an attorney experienced in commercial law, mergers and acquisitions.

If you manufactured your own products as outlined in strategy #2, during the two year period you would have earned a gross profit of about $1/2 million.. -- and you would have paid tax on about $1/2 million.

If you plowed the majority of that profit back into the company on continued R&D or production expansion, you are essentially converting "tax-deferred" income into additional plant, equipment or other depreciable assets.

As time goes on, you have not only earned this profit on the sale of products, but you have built an infrastructure which has a balance sheet value. Quite possibly, during this period, you could build up assets of more than $1,000,000 in a company which is running at a rate of $1-1/2 million in sales per year.

Using gross numbers to show the concept: If similar companies in your industry which are on the public stock market with a P/E of 15, lets say, the value of the issued stock in you company is 15 times the earnings (earnings of $250,000/yr). If you owned 50% of the stock, your personal worth or "value" could approach $1,875,000 -- significantly more than the half-million we spoke of earlier.

Some "rules of thumb" place the value of the company at one to three times sales. Using this formula, your 50% ownership in a company with annual sales of $1,500,000 would be $750,000 to $2,250,000 -- again, within the $1,875,000 range and significantly more than the $250,000 per year.

Items which could add additional value to the company's worth might include multi-year sales contracts with price increase clauses, licenses of patents or products to other companies which serve other non-competitive growing market segments, and a host of others.

Suffice to say that if you have the mettle to hang tough in the business startup environment, are able to assemble a top-notch team to assist with all of the operational areas of the company (sales, finance, production, design, marketing, and so on), your chances of making the big bucks are maximized when compared to the first two strategies.

I have gone the gambit, and prefer strategy #3. My last company sold to a Fortune 100 company, and although I cannot compete in the same market as the one served by the acquiring company, my intellectual property, customer contracts and operating infrastructure proved highly valuable to the buyer.

In Summary

By now, you can see that the business strategy you will pursue to achieve the highest commercial success and financial reward for your invention is as important -- if not more so -- than the idea itself. This "Intellectual Property Business Strategy For The Independent and Small Business Innovator" series will serve as a primer to intellectual property value strategy -- and I hope as a model for your future success.

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