The VC’s playbook:
Diligence essentials for technology-based IP

VC investments can improve monetization options and mitigate risk when diligence considers IP assets from a holistic business perspective, beyond the traditional legal opinions.

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From a macroeconomic view, real economic growth per capita in the US has one constant driver: productivity gains via technology progress. American history shows a virtuous cycle of investment, technology progress, economic growth, and reinvestment. And modern innovations promise to reverse the recent slowing of productivity, with advances in cloud computing, data mobility, artificial intelligence & machine learning, robotics, and genomics.

The microeconomic level is where individual firms compete and investors capture some portion of the value created from such technology innovations. Today’s most valuable companies, by market capitalization, are rooted in technology, and many of the now-household names were originally funded by venture capital. Given their past financial success, venture funds continue to deploy tens of billions of risk capital annually into the US entrepreneurial ecosystem. Accordingly, venture funds play an integral role in allocating capital to potential disruptors, namely younger firms that can’t or don’t access the traditional US capital markets for equity and debt.

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In terms of making informed bets, investors in public equities can discern both operating history and some technology advantages, whereas VCs grapple with myriad uncertainties. Candidates for venture investment will leverage technology-based intangible assets to disrupt incumbent business models and ideally capture a portion of the large profit pool. Strong IP rights can enable market entry and provide a mechanism for value capture by smaller entities; an imperative given that large incumbents enjoy brand and scale advantages. Further, while winning in the marketplace requires a combination of resources and capabilities, IP protection is mission-critical in sectors like life sciences.

Thus, when doing venture-stage diligence on a candidate’s IP rights, fundamental business questions should include:

- What is the intrinsic value of current and in-process IP?
- Does this IP provide an advantage in disrupting large market(s)?

- How and when can we realize the value given the current and projected environment?
- How do we balance investment in IP versus product development or marketing?

Yes, legal diligence should also inform investment decisions, with tests like ownership, pending third-party demands, assertion entity risk, and freedom-to-operate. But those legal opinions don't answer the above questions.

The following steps of IP diligence go beyond the legal checkboxes to inform economic decision-making:

1. **Strategy**: What are the business issues and is there a basic IP strategy that addresses these opportunities and threats?
2. **Assets**: What is the inventory of technical IP, including patents, trade secrets, software?
3. **Alignment**: How do the existing assets align with strategy, particularly the current and future products?
4. **Landscape**: How are the assets positioned relative to others?
5. **Optionality**: Could the IP extend to applications beyond the core business?

In addition, external events influence the above understanding of internal resources, competition, and customer/market needs. Specifically, recent changes in US legislation and case law have rewritten optimal IP strategy development and execution, particularly in focal industries for venture capital, such as software, IT, medical devices, media, and financial services. Similar considerations of patent and trade secret value extend to evolving IP protections in countries like China. A strong framework for enforceability will attract the flow of capital. For example, a robust patent regime provides incentive to pursue breakthrough, longer-term ideas, which already face long odds to commercialization. On the other hand, a patent system with asymmetric costs and uncertainties will favor large incumbents, who may choose to infringe on a new entrant's rights with near impunity.

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Across most VC-intensive sectors, candidate investments require higher quality and more focused IP rights to improve the likelihood of returns. With this broader, business-oriented perspective of IP diligence, investors can mitigate and/or diversify their risk. In addition, post-investment, they will have a stronger base of IP rights from which to capture opportunities.

About ipCapital Group

ipCapital Group (ipCG) is an innovation and intellectual property (IP) consulting firm serving clients that range from early stage to Fortune 500 in over 800 engagements since 1998.

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