Managing Equity Obtained via Technology Licenses

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This paper discusses the issues to consider when managing an equity position as part of a technology license agreement. Understanding those issues and how to manage them plays a crucial role in realizing a realistic return on equity (ROE). Failure to manage can result in significant value lost.

With concentrated, single-stock portfolios, investors must turn to ways to manage systematic and unsystematic risk. This paper looks at these single-stock risk-management issues.

Why Take an Equity Position?

Licensing institutions will often opt to take an equity position when available from their licensees. Numerous reasons exist and may include the following:

- Equity allows for additional upside revenue beyond the royalty or licensing fees.
- It may be seen as a risk premium to induce the licensor to license to a startup company licensee versus a more established licensor.
- Equity allows a licensee who is cash poor and equity rich to substitute an ownership position for a cash payment, e.g., for upfront licensing fees and/or for a reduced royalty rate.
- Equity allows the licensor to participate in the additional value a licensee obtains, either as a direct or indirect result of the license.

The discussion in this paper assumes that equity granted in a license agreement is not managed as part of a portfolio of stocks, but as a single-stock portfolio. That is, each position's returns and risk are managed individually and not aggregated with returns from other equity positions. In addition, it is assumed that many positions are large enough to be considered concentrated stock positions.

Modern portfolio theory and the capital asset pricing model posit that individual stocks carry systematic (market) risk and unsystematic (idiosyncratic) risk. In a properly constructed portfolio, you can diversify away most of the unsystematic risk. Then, the focus turns to managing a portfolio within the framework of systematic risk. However, with concentrated, single-stock portfolios, investors must turn to ways to manage systematic and unsystematic risk.

Private vs. Public Equity

First, let's distinguish between private and public equity. *Private equity* simply comprises ownership of companies that have no public market available. Sales of the equity can occur on a private transaction basis between two parties. One buyer may purchase all of the shares of another company, as in a merger or acquisition transaction. In this case, minority shareholders (such as university licensors) have little input, because the timing, price, and other transaction details are determined by the majority buyer and seller. In these cases, the minority equity holders have relatively easy decisions to make because they generally can only vote for the deal up or down.

Mergers or acquisitions (M&A) may convert a private equity position to a public equity position. For example, an acquisition may occur where the acquiring company is publicly held and pays for the acquisition with shares of its stock. Thus, the equity holders of the original private company swap their nonpublic shares for the publicly traded shares.

Obviously, an initial public offering (IPO) creates another opportunity for a privately held company to convert its shares to public equity.

The remainder of this paper assumes that technology licensors hold equity as minority shareholders. This paper also assumes that a technology licensor holds, or will hold, equity that will be tradable within a public market. Therefore, the timing and pricing decisions (sell or hold) rest solely with the equity holder and do not relate to larger M&A transactions with the rest of the company.

The Valuation Problem

Equity negotiated as part of a license agreement is very difficult to value since the licensee typically is a high-risk startup company with no marketable value and few tangible assets. Indeed, the license itself may represent the most valuable asset a startup company possesses. When a licensor accepts equity as part of a technology transfer transaction, the licensor usually attributes a low, or zero, cost basis to the initial equity position. Therefore, if the company succeeds in adding value to the equity position, the licensor believes it is immediately in a profitable position, with an unrealized gain. This inability to value the equity creates a complacency problem.

How many technology licensors determine the target internal rate of return (IRR) for their equity positions prior to entering into a license agreement? The percentage is probably low. One might argue that such a number cannot be calculated fairly, since the initial investment (or cash outlay) is thought to be zero. Prior costs (such as research and development) associated with the licensor for developing a new technology are generally not attributed to the licensee, so the equity position is not seen as an investment per se by the licensor. The licensor has no direct out-of-pocket financial investment in the license other than its own patenting expenses and administrative overhead. Therefore, any nonzero positive return provides a positive IRR and, similarly, a positive net present value.

The Problem of Selling

Technology licensors develop a unique psychology when managing equity derived from licenses. With no hard-dollar investment into the equity, there doesn't seem to be anything to lose; there's no capital at risk. And, with nothing to lose, the technology licensor may not strive as hard as other investors to capitalize on and take profits from the equity. While outside investors worry about their risk capital, ROI objectives, and the time value of money, technology licensors may be complacent about these same things. And questions arise: Who makes the decision to sell? At what price? When? Let's look at each of these factors.

Who Decides

In many cases, equity positions obtained from technology licenses are turned over to the licensor's chief investment officer or the treasurer. (Let's use treasurer for this example.) These people are generally very smart, financially savvy, and have a great deal of experience managing cash and investments for foundations and endowments. They certainly know the process for selling unrestricted, freely tradable securities. The treasurer, however, may have either no inclination or no experience in managing large, concentrated stock positions transferred to the organization by the technology licensing office. (These positions may even be referred to as orphan stocks.) The positions come to the treasurer with no cost basis, may be nonmarketable or may be marketable with restrictions, and may present substantial percentage ownership in one company. The securities may be restricted under SEC Rule 144, have lockup agreements, the institution may be deemed an insider or control person, and, therefore, subject to insider-trading restrictions, etc.

In other cases, the equity positions are managed by a committee of internal people comprised of technology transfer office (TTO) managers, the treasurer, and, possibly, other stakeholders (such as inventors, prominent faculty members, etc.).

Problems occur when the decision to sell or hold is managed without clear delegation of authority to act and without a clear desire to act. Whether authority rests with an individual or a body of people, if the decisions cannot be made in a timely manner, they may miss the market.

The Price to Sell

At what price should the equity be sold? The TTO may offer little direction, and the treasurer generally does not have the resources or analysts to determine a fair value for the company in question. Usually, small stock positions have little or no outside analytical coverage, so the Wall Street investment banking firms offer little help. What if the shares are sold at a point that's too low? Can the treasurer be criticized for acting prematurely? How can the treasurer know the best time to sell? He or she is too busy to time the market for a small stock position that may represent a fraction of a percent of the total assets he or she manages.

The treasurer may rightly believe that the liquidation of shares acquired via a technology license presents more work, and more internal liabilities, than it's worth. His or her best response is the easiest to execute: do nothing. The situation will often resolve itself—most startup companies will fail or the post-IPO price will wither to the point where the company is easily bought out or terminated. Ideally, the equity will be sold for cash as part of an M&A transaction, relieving the licensor of all pricing and timing decisions. Finally, for the small percentage of licensees that succeeds in the public market, the treasurer can deal with a more mature security position at that time (always at a later date).

In summary, in many cases, the TTO is expecting to get any reasonable ROE but has no clear goals about what that return should be or how best to obtain it. Meanwhile, neither the treasurer nor the larger institution has the time, resources, or inclination to devote to such orphan stock positions. Even worse, the treasurer may view any sales as creating new liabilities (such as insider-trading problems). Therefore, an approach based on doing nothing may be his or her best option. However, the small, newly minted stock is often a wasting asset as illustrated in the next section. Failure to act could squander its value.

When to Sell

The most straightforward strategy to manage public equity obtained via a technology license is to sell at the first opportunity following a liquidity event (such as an IPO). This seems amazingly simple and obvious, but it is not followed by a number of institutions. Many believe the price will go up following a liquidity event. Others have seen the price go down just as they are discussing the sale, so they will, therefore, hold on in hopes of a turnaround in the market. As mentioned above, with no frame of reference, such as financial analysis to determine a fair price, technology licensors default to the worst possible solution: do nothing out of a lack of information. What alternatives exist to the do-nothing strategy?

A study titled "The Expiration of IPO Share Lockups," published by Laura Casares Field and Gordon Hanka in the *Journal of Finance*[1], offers interesting insights into the sale of IPO stock. This study assumes that investors in a venture-backed company are subject to a lockup agreement. A lockup agreement is a contract put forth to existing private equity

shareholders in a firm that is about to go public. The investment bankers in charge of the underwriting for the firm usually require a lockup agreement as a condition of the underwriting, and standard practice calls for a 180-day lockup period following the date of the IPO. The lockup agreement prevents existing shareholders from selling their shares for a period of time so that new money raised in the IPO goes into the company, not to cashing out existing investors. (Some exceptions apply as specified in individual IPO prospectus documents.) Field and Hanka, therefore, focus their study on the unlock day rather than the IPO day because virtually none of the pre-IPO investors can sell on the IPO day.

They report that, "Around the unlock day, we find a permanent 40 percent increase in trading volume and a statistically prominent three-day abnormal return of -1.5 percent. Both of these effects are roughly *three times larger* in venture-backed firms compared to nonventure backed firms, and this "venture capital" effect grew stronger over our sample period." (Emphasis added.)

In other words, one of the best times to sell a position in an early-stage company is immediately following expiration of the IPO lockup (assuming this is the first opportunity to liquidate). It is even more important to do so if the firm is venture-backed, since venture capital firms will take their profits, immediately. VCs are among the very first sellers on the first day, the first minute that they can sell. They are not being disloyal to their venture-backed companies—indeed they took the risk in investing in the new companies in the first place. They are merely being true to their limited partners by taking profits as soon as possible.

This makes sense. VCs are not interested in holding cash or publicly traded securities after a liquidity event. Indeed, their partnership agreements often require them to distribute publicly traded shares or cash to their limited partners once a liquidity event has occurred. Finance theory expounds on this point too—investors should receive the returns as soon as possible because the investors can make better decisions with their money after the original investment has been liquidated. Technology licensors should follow this same process.

Note that this strategy does not involve a pricing decision, just a timing decision. VCs liquidate as soon as possible, independent of the current price. In a statistically significant number of cases, according to Field and Hanka, they would have lost value had they waited.

Recommended Approach for the Technology Licensor

From a psychological viewpoint, it's best to assume that every equity position received via a technology license represents a major hard-dollar investment by the licensor. Then, act accordingly, like other institutional investors. In other words, document in advance all decisions relating to the disposition of the equity, as much as possible, upfront.

This approach requires the institution to develop a set of strategies and policies to guide them in the management and sale of equity positions. This is not merely a set of policies to discuss how cash proceeds following the sale of equity may be distributed. This is more comprehensive and provides guidance from the first day a license is signed that attributes equity to the licensor.

The key guiding principle is the same as that used by an endowment's treasurer: act like a responsible fiduciary. This requires adherence to a basic principle that any endowment officer knows: develop an investment policy statement for the portfolio.

Develop a Liquidation Policy Statement

Foundations and endowments have investment policy statements (IPS) to guide their overall decisions for their portfolios. A typical IPS provides guidance about an endowment's goals, such as spending policies, targeted rates of return, etc. However, a technology licensor can certainly develop a modified IPS, such as a liquidation policy statement (LPS) to stipulate the sell discipline to be invoked for a security acquired through a license.

Taking the time to draft and execute an LPS for a single-stock portfolio may add significant value to the position. The LPS will serve as documentation for the treasurer, the TTO, and all stakeholders involved. By instituting it early in the process (when the equity has little or no value), it can be discussed and amended easily and obtain requisite approvals from all concerned parties.

Overall, an LPS guides the licensor so that all parties clearly know the sell discipline for XYZ Co. That is, the LPS invokes a documented manner and time to sell. The LPS should contain the following basic parameters:

- Preserve capital by providing protection against a decrease in the value of a stock; commit to a sell discipline.
- Diversify the exposure from a single-stock holding; commit to multiple single-stock risk-management strategies.
- Institute mechanisms to monitor results.

Let's explore these first two items in greater depth.

Sell Discipline

The licensor's sell-discipline should be no different than the VCs as discussed above. The equity licensor should simply take profits at the first opportunity or distribute the publicly held shares to the stakeholders as soon as possible. Then, if the institution wants to speculate with its own retained equity position (apart from those shares that would be distributed), it can do so. Certainly, exceptions to every rule exist. In my own experience working with the liquidation of venture-backed companies, following this simple rule provides a high ROE compared with strategies based on holding (and speculating with) the security after the IPO lockup expires.

Diversification: Including Other Single-Stock Risk-Management Strategies

Reasons may exist to deviate from the simple sell rule noted above. When an investor holds a concentrated stock position, he or she may choose to use a variety of strategies to manage the risk of holding that position. In a single-stock portfolio, diversification of assets is impossible. However, risk can be managed by diversifying among the strategies for managing the single stock.

Beyond the simple sell strategy, risk-management strategies may also include any or all of the following:

1. Hedging strategies
   a. Put option
   b. Equity collar
   c. Range forward sale
2. Liquidity strategy: prepaid forward sale
3. Speculate: hold shares for upside appreciation

Note that the first two strategies require a brokerage firm with sufficient expertise to act as the counterparty to establish these customized over-the-counter transactions, which are also known as *structured derivatives*.

An LPS might contemplate the use of multiple strategies. For example, an investor with 300,000 shares of stock may diversify this concentrated position as follows:

1. Commit to selling one-third of the position (100,000 shares) as soon as possible (within the boundaries of any lockup agreement, Rule 144, etc.).
2. Enter into a two- year, zero-cost, equity-collar contract for another one-third position.
3. Hold another one-third of the position as a speculative position, given that there is upside appreciation possible.

Certainly, an equity owner may combine these strategies in a variety of ways. This serves as only one example to manage current risk by liquidating a portion of the position, manage downside risk with a collar, and manage upside risk by retaining a portion for possible price appreciation.

Options

For more about options, hedging, and structured derivative strategies for concentrated stock positions, please contact the author at gregory.w.hauth@smithbarney.com.

Conclusion

Marketable equity obtained via technology license agreements can offer good returns to technology licensors if managed properly. Clear delegation of responsibility, a written liquidation policy statement, and strategies to control for risk in concentrated positions will preserve or accrue value to the position. The technology licensors must comply with contractual obligations (lockup agreements) and regulations (SEC rules) that make management difficult. Using liquidation strategies properly can help the technology licensor achieve a better return on equity than a do-nothing strategy.

The views expressed herein are those of the author and do not represent the views of the broker-dealer for whom he is employed, its officers, directors, or its other employees.

Notes

1. "The Expiration of IPO Share Lockups," Laura Casares Field and Gordon Hanka, *Journal of Finance*, 06/2000, p. 4.