Step 1 - Understand

If you really want to ***understand*** why your company's sustained profitability almost inevitably depends on its successful exploitation of the intellectual properties that protect its most valuable innovations, know-how, and brands, then this Guide was written for you.

What you'll learn

- What really impacts profitability?
- What enables sustained profitability?
- How vital is intellectual property to sustaining profitability?
- What is the intellectual capital management model?
- What are the fundamental steps of the innovation process?
- How can IP protect innovations, know-how, and brands?
- In what basic ways can IP be exploited for profit?

Achieving Profitability – Innovate

When most business people talk about profitability, that is, the ability to earn financial profits, they tend to focus on the economic contributions of commonly-recognized components of operational effectiveness, such as product or service features, cost, price, sales volume, quality, service, and relationships. Certain measurements of these components can address how well a business has performed its chosen activities with respect to its rivals. Occasionally, business folks mention how profits are affected by strategic positioning, that is, what activities the business has chosen to perform, and in particular, how its selected activities differ from those of its rivals. Sometimes, the conversation turns to the impact of competitive forces, which includes the activities associated with the incessant jockeying for position among current competitors. Much less frequently discussed, competitive forces

also include the threat of new market entrants, the leverage of suppliers, the threat of substitute products or services, and the bargaining power of customers.

Of course, merely *achieving* profitability is rarely the motivation for prolonged conversation. Instead, the supreme goal, the consuming desire, and the most intense craving is nearly always for ***sustained profitability***, which is so richly rewarded, yet so difficult to obtain. Surprisingly however, when experts talk about sustained profitability and the challenges of obtaining it, they point out that *simply improving operational effectiveness alone is usually futile*. Yet that's the most commonly followed path among those striving for sustained profitability.

So what *is* the answer? Is the quest for sustained profitability truly hopeless, and doomed to failure? Experience and casual observation teach us that the correct answer is an emphatic "NO!" Certainly a least a few companies have achieved sustained profitability, at least for a reasonably prolonged period of time (Apple, Google, GE, and lots of smaller companies quickly come to mind).

So what then, are the requirements for achieving sustained profitability?

Acclaimed strategy expert and Harvard Business School Professor Michael Porter suggests that:

> *"**A company can outperform rivals only if it can establish a difference that it can preserve**. It must deliver greater value to customers or create comparable value at a lower cost, or do both. The arithmetic of superior profitability then follows: delivering greater value allows a company to charge higher average unit prices; greater efficiency results in lower average unit costs."* [1]

STEP 1 - UNDERSTAND

Sustaining Profitability – Own The Profits

To find the bottom line answer, we turn to some different experts, Mark Blaxill and Ralph Eckardt. Here's what they say:

> *"the key to competitive advantage is to own the distinctive parts of your business that create value. And* ***the only way to truly own your distinction is through intellectual property****.... With the right IP, companies can command premium prices, increase market share, sustain lower costs, and even generate income directly. Without it, their products (and services) lack* ***differentiation****, and they can only compete on price. Businesses that have no IP are, by definition, "commodity" businesses that, no matter how well run, lack any sustainable edge, and are destined to limp along on razor-thin margins, subject to the vagaries of supply and demand."* [2]

These guys should know what they're talking about. Blaxill is the former senior vice president of Boston Consulting Group, which trumpets itself as the "world's leading advisor on business strategy". Eckardt is the former head of the Boston Consulting Group's intellectual property strategy practice. In their excellent book, "*The Invisible Edge – Taking Your Strategy to the Next Level Using Intellectual Property",* Blaxill and Eckardt provide plenty of compelling evidence and powerful arguments to support their views.

For example, they explain that:

> *"Any business strategy not built around intellectual property is no strategy at all. Why? Well,* ***without intellectual property protection a business can have no sustainable advantage over its competitors****. Without sustainable competitive advantage, the odds of developing and sustaining outstanding profit performance plummet. Without an expectation of outstanding profit performance, businesses have little incentive to invest in innovation. Without innovation, the opportunity for growth vanishes. And without growth opportunities, the potential for wealth creation and generating high returns for shareholders disappears. Just about any way you look at it, a modern business needs to place intellectual property strategy close to the center of any strategic plan. Anything else amounts to negligence."* [3]

STEP 1 - UNDERSTAND

Wow. Strong words indeed. Here's a few more.

> *"After years of experience in the strategy development process, we have become convinced that* ***intellectual property protection is the missing ingredient in most executives' strategy toolkit.*** *They don't talk about it much, they don't think about it enough, and they don't know how to manage it very well and as a result their business performance suffers. But* ***the evidence is clear*** *if you take a hard look at business performance:* ***highest business returns go to intellectual property-based businesses*** *and that outstanding profit performance results directly from the limited market power that valuable intellectual property provides. Indeed, these profit results are well deserved, for it is the companies who innovate rapidly and compete aggressively that profit the most. Yet as we know, when competitors smell profits they come running, so* ***without some form of protection,*** *those* ***competitors will quickly copy the innovations and drive the profits (for both the innovator and themselves) down to nothing****."* [4]

Finally, Blaxill and Eckardt reveal that:

> *"In hindsight it seems obvious – intellectual property is the indispensable but unheralded key to understanding businesses, markets, and economies in the modern era.... IP is rapidly becoming the central foundation of businesses and markets, the most precious resource in the world, and the most important source of newly minted wealth...."* [5]

So perhaps it should come as no surprise that

> *"[c]onservative estimates say that annual intellectual capital investments have grown exponentially to more than $1 trillion in the United States".* [6]

Of course, investors also have a nose for profits, and high expectations of achieving them. So with investments of that magnitude, it becomes clear why Blaxill and Eckardt proclaim that "*whoever owns the IP owns the profits*". [7]

My decades of business and legal experiences suggest a very similar observation. ***You must own the IP to own the profits.***

Step 1 - Understand

Let's take a closer look at why that rule seems to be universally true.

Recognizing the Extent of IP's Impact

If you want a little more evidence of the importance of IP, not just to individual companies, but even to the entire U.S. economy, consider a few broad statistics:

- In 2010, intangible assets were responsible for 80% of the market value of the S&P 500 companies. [8]
- U.S. intellectual property is worth between $5.0 trillion and $5.5 trillion – roughly 45% of gross domestic product (GDP) and more than the GDP of any other country. [9]
- IP-intensive industries employ 18 million Americans. [10]

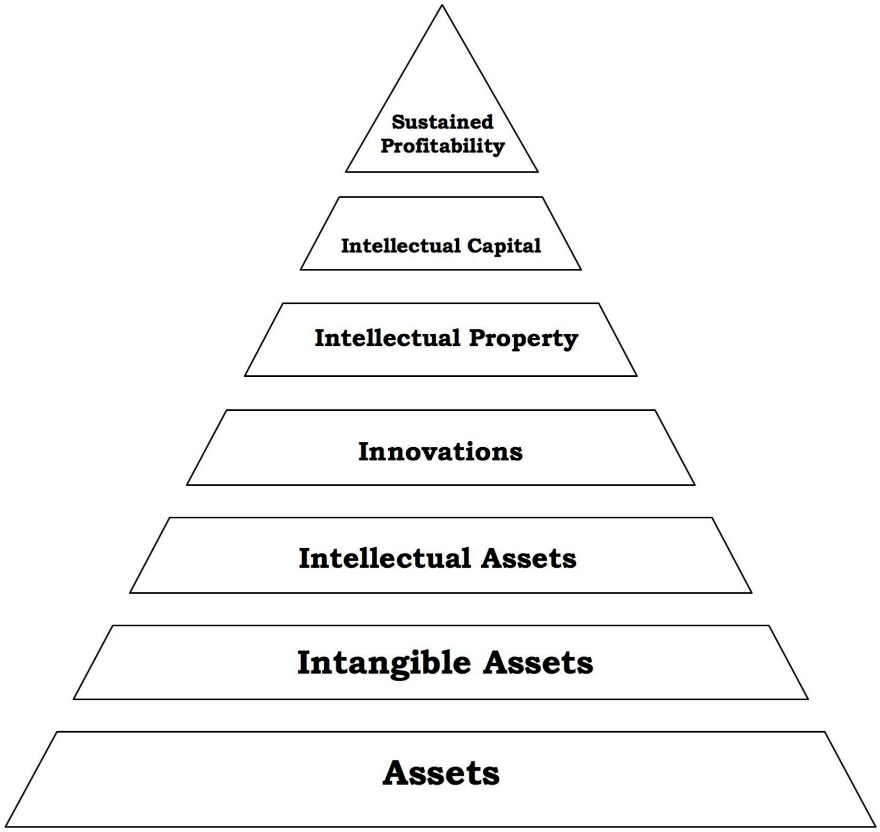
With those statistics in mind, consider this quote from U.S. President Barack Obama:

> *"Our single greatest asset is the innovation, ingenuity, and creativity of the American people. It is essential to our prosperity and it will only become more so in this century."* [11]

Modeling Intellectual Capital Management

To better understand the relationships between knowledge, innovation, and intellectual property, and particularly how they are connected to sustained profitability, I have developed this pyramid-style model of Intellectual Capital Management:

STEP 1 - UNDERSTAND



As shown, at the base or level 1 of this pyramid are **Assets**, which include tangible, monetary, and intangible assets. Nearly every business person is intimately familiar with tangible and monetary assets. Tangible assets include a company's land, buildings, equipment, inventory, and supplies. Monetary assets include the company's cash, accounts receivables, and bank balances.

But of the 3 types of assets, probably the most important to this model are **Intangible Assets**, which are shown on level 2. As a rough measure of their relative significance, consider that nearly a decade ago, the U.S. Federal Reserve Bank of Philadelphia estimated that annual U.S. investment in intangible assets had steadily increased to over $1 trillion dollars per year, and roughly 20 years ago overtook U.S. investment in tangible assets.

STEP 1 - UNDERSTAND

So what are intangible assets? Intangible assets are non-monetary things of potential value that typically are thought of as not requiring physical storage space. Examples include a company's knowledge, skills, data, software, organizational structure, employee motivation and flexibility, R&D, legal and marketing activities, brands, reputation, goodwill, agreements, and relationships, etc. I have identified over 40 such examples in 7 major categories, and I'm happy to share them on request.

One of the more notable and broad classes of intangible assets is "*knowledge*", which is the understanding of a topic obtained by education, experience, and/or insight. In recent years, many companies have discovered and harnessed substantial opportunities involving "*Knowledge Management*", which I define as the systematic and disciplined strategies and processes for proactively creating, gathering, filtering, organizing, representing, disseminating, leveraging, and using knowledge, potentially originating from any source, to make decisions, cause action, and generate value.

Moving up to level 3, some intangible assets can be codified, that is, recorded (via text, graphics, photo, audio, video, animation, etc.) so they can be perceived later in time. If they provide value to a company, such codified intangible assets are referred to as **Intellectual Assets**, and can include knowledge, brands, and agreements.

At level 4 are **Innovations**, which are new intellectual assets, associated with goods and/or services, that result from the Innovation Process. I define the "*Innovation Process*" as the act of introducing something new, such as a new product or service, for economic benefit, based on the application and integration of existing intangible assets, such as knowledge, relationships, and/or attitudes to generate new intellectual assets ("innovations") that are associated with (embodied in, branded/labeled on, etc.) the newly introduced thing.

Rising higher up the model, we next come to level 5, **Intellectual Property**. Simply stated, intellectual properties are legally protected, or owned, intellectual assets. Such legal protection typically arises in the form of patents, marks, and copyrights. The owner of such protected intellectual assets holds legally enforceable property rights in those assets. That is, the owner can seek damages from infringers (which are analogous to "trespassers") of those property rights.

Nevertheless, only a minority of all intellectual properties have significant value, so at level 6 we find **Intellectual Capital**, which is significantly valuable intellectual property. On a closely related note, I refer to the systematic and disciplined strategies and processes for proactively extracting the value inherent in a company's valuable intellectual properties as "Intellectual Capital Management".

When performed well, I argue that Intellectual Capital Management (along with strong management of the Innovation Process, intellectual assets, and IP) can lead to golden level 7, **Sustained Profitability**, which, expressed most optimistically, is the state of continuously earning above-market net profits throughout the life of a company.

So finally, there it is... at the top of the pyramid... the holy grail of nearly every company... ***Sustained Profitability***... that state of continuously earning above-market net profits throughout the life of a company.

Wow. Sounds great... if you can get it!

But what specifically must a company do to achieve sustained profitability? To learn more about Intellectual Capital Management and how it can lead to Sustained Profitability, let's first take a closer look at level 4, Innovations, and the Innovation Process that facilitates them.

Managing the Innovation Process

Before describing the fundamental steps of the Innovation Process, let's consider what exactly IP protects, and answer a fundamental question: ***What is innovation?***

Here's what a few experts say:

☛ *"Innovation is the process of turning ideas into manufacturable and marketable form."*

  Watts Humphrey, Vice President of IBM, Professor at Carnegie Mellon, recipient of the National Medal of Technology, and sometimes called "the father of software quality".

STEP 1 - UNDERSTAND

- *"Usually, managers equate innovation with creativity. But innovation is not creativity. Creativity is about coming up with the big idea. Innovation is about executing the idea – converting the idea into a successful business."*

  Vijay Govindarajan, Chief Innovation Consultant to General Electric, Professor of International Business at Dartmouth College, and one of the world's leading experts on strategy and innovation.

- *"'Innovation' is not just inventions; it is a process of making changes by introducing valuable new methods, ideas, or products.... Innovations may of course be inventions, but they may also be beliefs, organizational methods, and discoveries. An innovation is a value-creation mechanism. It is the way we humans manage to extract more value".*

  Lawrence Husick, From Stone to Silicon: A Brief Survey of Innovation, Footnotes, The Newsletter of the Foreign Policy Research Institute's Wachman Center, October 2008.

These quotes should enrich your view of what innovation is, but to be complete, here's another fundamental and closely related question we ought to briefly investigate: ***Why is innovation so important***?

Again we turn first to some experts for their insights:

- *"**Innovation distinguishes** between a leader and a follower."*

  Steve Jobs, Founder and CEO of Apple, Inc.

- *"**Wealth flows directly from innovation**... not optimization... wealth is not gained by perfecting the known."*

  Kevin Kelly, founder and editor of *Wired* magazine, publisher of *Whole Earth Review*, author of *What Technology Wants*, and publisher of the *Cool Tools* website.

STEP 1 - UNDERSTAND

Excellent points and very well said. So let's just give these experts the benefit of the doubt and assume that innovation is very important to wealth creation, a critical component of Intellectual Capital Management, and definitely worth exploring a bit deeper.

From that foundation, I propose that, not only must the typical company own the IP to own the profits, but to succeed over the long term, that company must excel at fueling its IP by intensively implementing a continuous and iterative ***Innovation Process*** that includes:

1. discovering the market's needs;
2. innovating to meet those needs;
3. identifying, proving, and analyzing its innovations;
4. determining the value of its innovations;
5. strongly protecting its most valuable innovations;
6. marketing its protected innovations; and
7. harnessing the power of its innovations.

Although we'll explore each of these components of this general Innovation Process in much greater depth throughout my free Guides, let's very briefly touch on them now.

At least several of the items on this list should make complete sense. For example, frequently, by rationally gathering, organizing, and analyzing market feedback, a company can gain critical market insights, learn where innovation is needed, and discover how best to tailor its innovations to truly satisfy the market's needs.

Perhaps most importantly, I have found that at least 10 to 20 valuable, protectable, and documented innovations can be generated via application of a structured 4 to 5 hour innovation session.

But regardless of how they are generated, as emerging innovations are identified, they can be tested for how effectively they function. Also, they can be analyzed for how well they can

fulfill the market's actual needs, how protectable they are, and how valuable they are likely to become. Assuming an innovation meets identified criteria, including economic criteria for profitability, such as risk-adjusted return on investment, strong IP protections can be sought for that innovation.

With sufficient IP protection in place or underway, your company can create and roll-out thoughtful communications that persuasively advocate an innovation's benefits to its target markets.

Leveraging the power provided by owning the rights to the IP underlying an innovation, your company can then exploit that innovation and/or its IP by any of dozens of techniques.

Protecting Innovations via IP

When all goes well, the Innovation Process introduces something new, such as a new product or service, that fulfills a previously unsatisfied market need. To the extent that new product or service embodies or utilizes a new intellectual asset, such as know-how, an innovation, or an artistic creation, intellectual property protection can be sought. If obtained, intellectual property protection will provide legal rights with which to exclude competitors from making, using, selling, or otherwise exploiting that new intellectual asset.

The legal remedies for violating property rights, however, can include not only monetary damages, but also injunctions (court orders compelling an entity to do or stop doing something) and seizures. Sometimes, a court will issue an order requiring the violator to pay punitive damages, the attorney's fees of the IP owner, and/or other litigation-related costs. In a few situations, and unlike breaching contractual rights, violating intellectual property rights can even result in criminal penalties.

But while ownership is required, it is not quite enough, for ownership won't necessarily ensure that the world will beat a path to your door, gladly pay whatever price you demand, and provide you a growing pile of profits. Instead, considering the bigger picture, it becomes clear that taking a few more steps for harnessing the value and power of your company's IP can be critical to its long-term success.

STEP 1 - UNDERSTAND

Extracting Value and Power from IP

Although I address this topic in great detail in my free Guide, *"Empowering Intellectual Property - Step 7 – Harness"*, it is worthwhile to recognize now that harnessing the value and power of your company's intellectual assets and IP can take any of many, many forms.

For example, your company might rely on its intellectual assets and/or IP to earn enhanced profits or licensing revenues, discourage competitive activities, and/or raise the market's perception of your company's value.

Some harnessing opportunities might provide your company with market exclusivity, along with the attendant extraordinary profits and the power to obtain injunctions, exclusion orders, seizures, and monetary damages against proven infringers. Other opportunities might involve negotiating the license or sale of intellectual assets and/or IP combined with lucrative supply agreements, technical consulting, and/or know-how sharing.

Somewhat less apparent, but equally important possibilities for your company might include divesting under-utilized assets and avoiding risks, such as preventing, mitigating, and resolving disputes, lawsuits, and related liabilities.

On occasion, it can be worthwhile for a company to harness its IP power by:

1. using IP as collateral to fund other projects;
2. donating IP to a charitable organization; or
3. placing IP into the public domain to prevent others from obtaining exclusive control of slight improvements or modifications to it.

Beyond measurable financial returns, the growing strength of your company's intellectual assets and IP portfolio can highlight your company's innovativeness and skills, encourage investors and early adopters, deter aggressive competitors, attract cooperative business relationships, and provide further leverage in licensing negotiations.

STEP 1 - UNDERSTAND

These are just a few cursory examples of the huge number of ways that the value and power of intellectual assets and IP can be harnessed.

But before we investigate in greater detail how your company can exploit its intellectual assets and properties, we need to briefly cover a few other topics, including how to manage its innovation process, how to secure the resulting innovations with IP protections, and how to evaluate, tailor, and target your IP for its intended market. And to lead off that discussion, I start by explaining, in my free Guide, *"Empowering Intellectual Property - Step 2 – Strategize"*, how your company can create and manage a high-level or strategic plan that will guide all of your company's IP-related activities.

Free Tips

Like my free Guides? Then *click this link* to sign-up to periodically receive, via e-mail, my free Tips for empowering your intellectual property.

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Endnotes

1. *What is Strategy*?, Michael Porter, Harvard Business Review, November-December 1996, page 4 (*emphasis added*).

STEP 1 - UNDERSTAND

2. *The Invisible Edge – Taking Your Strategy to the Next Level Using Intellectual Property*, Mark Blaxill and Ralph Eckardt, 2009, pages 10-11 (emphasis added).

3. *Id.*, page 44 (emphasis added).

4. *Id.*

5. *Id.*, page 10.

6. *Id.*, page 45.

7. *Id.*

8. *Ocean Tomo's Annual Study of Intangible Asset Market Value - 2010*, Press Release, 4 April 2011.

9. *The Economic Value Of Intellectual Property*, Robert J. Shapiro and Kevin A. Hassett, USA For Innovation, October 2005.

10. *Engines of Growth: Economic Contributions of the U.S. Intellectual Property Industries*, Stephen E. Siwek, Economists Inc.

11. U.S. President Barack Obama, speaking at Export-Import Bank's Annual Conference, Washington, D.C., March 11, 2010.