

## Book Review: The Open Innovation Dilemma for VCs

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In 2003, Henry Chesbrough – then at Harvard Business School, now at UC Berkeley’s Haas School of Business – published a insightful book called *Open Innovation*. In it, he disabused any notion that the traditional “closed”

model of innovation as used by Bell Labs, Xerox PARC, and IBM of the 1970s had a future in the 21<sup>st</sup> Century. This “closed model” (see Figure 1) assumed that a corporation would develop all the technology it needed and throw away or shelve anything that didn’t fit its business model. No technology would “flow” through the corporate firewalls, preventing external innovation from being used in the organization and internal innovation from being monetized elsewhere

At the time, what caught the attention of many corporate strategists and investors was that this showcased how they still struggling to adapt to the new world order of innovation. But what would be a business book without a solution? Chesbrough described an open innovation model which is much more fluid and flexible. Chesbrough’s open innovation model (see Figure 2) included inbound and outbound licensing, product line acquisitions and Corporate IP Spinouts, and corporate venture investing as well as partnerships with institutional VCs and research institutions both here and abroad.

### Open Business Models

In his latest book, Chesbrough has gone to the next step and linked the emerging model of open innovation with emerging business models. Titled *Open Business Models*, Chesbrough does a superb job of outlining how to get economic value out of technology innovation and intellectual property (IP). This is not completely new ground – Kevin Rivette and David Kline argued in *Rembrandts in the Attic: Unlocking the Hidden Value of Patents* (1999) that corporations are sitting on veritable gold mines of latent IP value which they can unlock if they would just dust off those unused assets. Sounded easy, but many licensing executives have broken their picks trying to mine this elusive gold vein. As the Wall Street Journal said when it reviewed Chesbrough’s *Open Business*

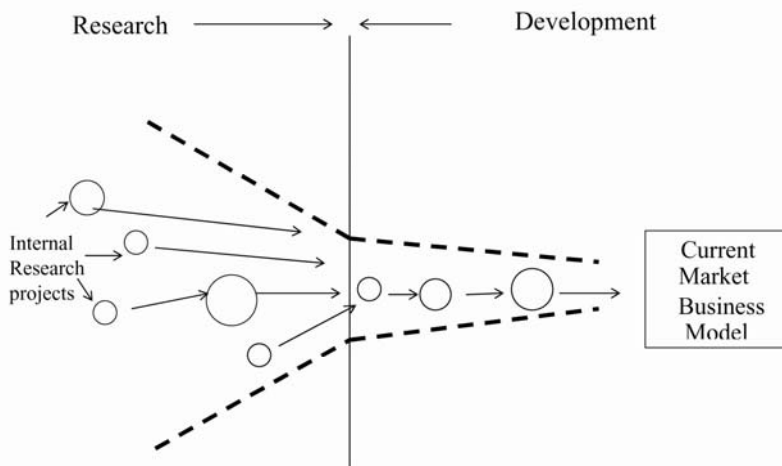
business to extract IP licensing royalties) with the result that companies such as IBM are now the target of many troll lawsuits – and that IBM has recently hired Kevin Rivette to help them figure out a strategy to cope with the trolls. Perhaps bit of IP karma?

### Purple IP Haze

Last year’s \$612M settlement between RIM and NTP made many investors take notice of the economic opportunity of IP – as well as its pitfalls. Nathan Myhrvold – former Microsoft *uber*-CTO – is creating a fair amount of press with Intellectual Ventures, his well-heeled platform which is gobbling up patents (2,500 at last count) as well as filing them (over 400 in 2006). After cover stories in Fortune and Business-Week last year, Intellectual Ventures is

no longer under the radar screen. Still the question remains: what will Myhrvold do with all of those patents, and when will his investors start to see some type of return? Ocean Tomo recently raised over \$200M in an effort to create a Sotheby’s style IP auction only to discover that patents aren’t ready for sale on QVC. In fact, few of the patents that were offered in their first two auctions fetched anywhere near the seller’s reservation price ... but they did learn that there is a lot of interest in Jimi

Hendrix music copyrights (\$15M of the \$21.7M raised in their October 2006 patent auction came from the Hendrix lot). Purple Haze indeed. And of course, it took a patent dispute to actually create sympathy for Microsoft when they were slammed with a \$1.52 billion dollar penalty as a result of a judgment that the Redmond gang had infringed Alcatel-Lucent’s MP3 patents.



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FIGURE: CLOSED INNOVATION MODEL

*Models* on Dec 21, 2006, “Chesbrough is not the first academic to grasp the superior value of intellectual over tangible property in today’s economy. But he may be the one who has thought most deeply about its consequences for business.” To that point, it is ironic that one unintended consequence of the patent license wave initiated by Rivette and Klein was to create more patent “trolls” (firms who are only in



Most recently, we've seen Vonage, last year's big telecom services IPO, enjoined from signing up new customers after they were found to be infringing VOIP patents held by Verizon. Oops.

OK, so IP is important. But is there an IP market? According to Chesbrough, the answer is a definitive maybe. Historically, the market for IP has been illiquid, opaque, and inefficient. But Chesbrough shows that we might be at an inflection point for an IP market. New models such as Ocean Tomo and Intellectual Ventures might offer new hope for IP holders – and peril for IP targets. Chesbrough gives an honest appraisal of the prospects for both Ocean Tomo and Intellectual Ventures – both are still unproven, but they do represent well capitalized IP-based business model experiments that may ultimately succeed.

### Monetizing Soap?

Where Chesbrough shines is in showing ways to monetize IP by integrating IP management into a firm's business model and culture. No, this is not another book about how to license your patents. Instead, he advocates a much more holistic approach to getting the value out of your IP. He cites examples of diverse companies such as Procter & Gamble, Qualcomm, Air Products, and IBM, all of whom have all been able to integrate sophisticated IP management into their innovation life cycle. Under CEO AG Lafley, P&G instituted their Connect and Develop program whereby at least half of their innovation would come from outside sources. That has been well publicized. What is less known is the yin of this yang: P&G researchers can no longer sit on things they develop; the company forces any patented invention to be available for

external licensing or spinout within three years of shipping into the market or five years of patent issue. Why? To speed up the cycle time of innovation inside P&G. Astute VCs will be able to capitalize on this by helping to create new ventures where P&G didn't see a business opportunity. Venture firms which have the ability and desire to work with corporations to structure Corporate IP Spinouts will be well positioned to generate value in this new model.

Chesbrough's analysis of Qualcomm is also instructive in how to get maximum value out of IP. Tech watchers have marveled at Qualcomm's ability to generate high margin royalties on their wireless IP such as their CDMA patents. What many people don't realize is the large investment the company made to build handsets and large networks to convince carriers to adopt CDMA – they had to *prove* the business model before people would pay them CDMA royalties.

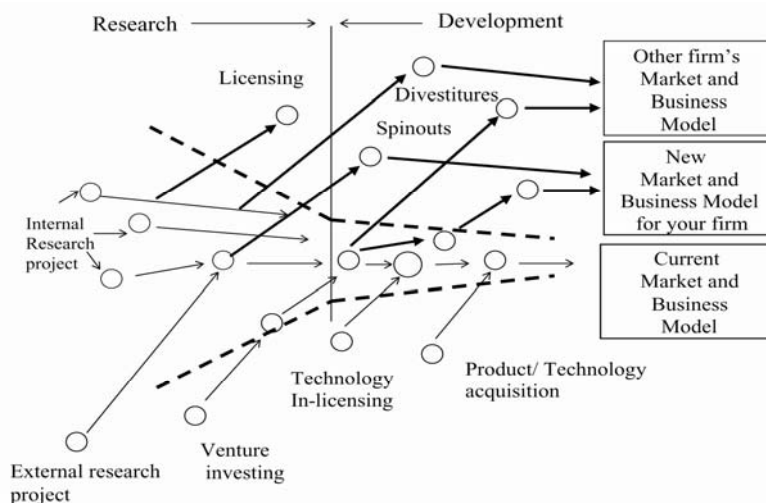
Now that they have sold off their initial investments in this infrastructure, Qualcomm may appear at first blush to be a veritable cash machine – but this is only the result of many years, millions of dollars, and a fair amount of risk taking. Bottom line, Qualcomm had to demonstrate the business model before they were able to start cashing any IP royalty checks.

### It's the Business Model, Stupid

So what does this mean for VCs? It goes without saying that innovation and IP are among the "must haves" of most successful technology-based ven-

ture-backed companies (along with great management teams and big potential markets). Typically, one of the first questions VCs ask an entrepreneur is to explain why what they have is better / different than what is already out there (the innovation) and how they can protect it (the IP).

All too often though, innovation is equated with IP. The reality is that innovation is about creating potential value, while IP is only one element – necessary but not sufficient. There are many entrepreneurs – and more than a few VCs – who have been sorely disappointed to discover that a large stack of patents is not a guaranteed ticket to success. So while IP is often a necessary element in the success of a ven-



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FIGURE 2: the OPEN INNOVATION MODEL

ture backed company, rarely is it sufficient and in practically all cases it must be wrapped with an entrepreneurial and market-minded management team. That's when IP begins to *really* shine.

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