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RPX Corp: Substantially Undervalued Patent Middleman Generating 70%+ EBITDA Margins Trading At 3x EBITDA

Jul. 12, 2015 4:20 AM ET 15 comments

by: Lester Goh

Summary

- Patent litigation is a multi-billion dollar industry, largely as a result of patent trolls. Due to their large numbers, companies are forced to direct resources and attention towards lawsuits.
- RPX helps companies drastically reduce their litigation exposure, with a unique business model that enjoys several durable competitive advantages.
- The firm's addressable market (patent litigation defense & insurance) remains largely untapped.
- The opportunity exists as most players within this space have a bad reputation, as many utilize their portfolio of patents in order to extract settlements/licensing fees from companies.
- I believe RPX Corporation is substantially undervalued at current levels (with 80%+ upside) even assuming no multiple expansion. Taking multiple expansion into consideration increases upside potential several-fold.

Landscape of patent litigation

Intellectual property laws were created in order to promote progress. The idea was that an inventor or creator would be deterred from performing their purpose (inventing and creating) if they did not have any protection of their works created. When IP laws were created, inventors and creators had sufficient incentive (particularly incentive of the financial nature) to come up with new products and services that would allow societal progress. If an inventor created a product that was beneficial for society, said product could be commercialized, and the inventor could pocket the profit derived. The model worked well for decades.

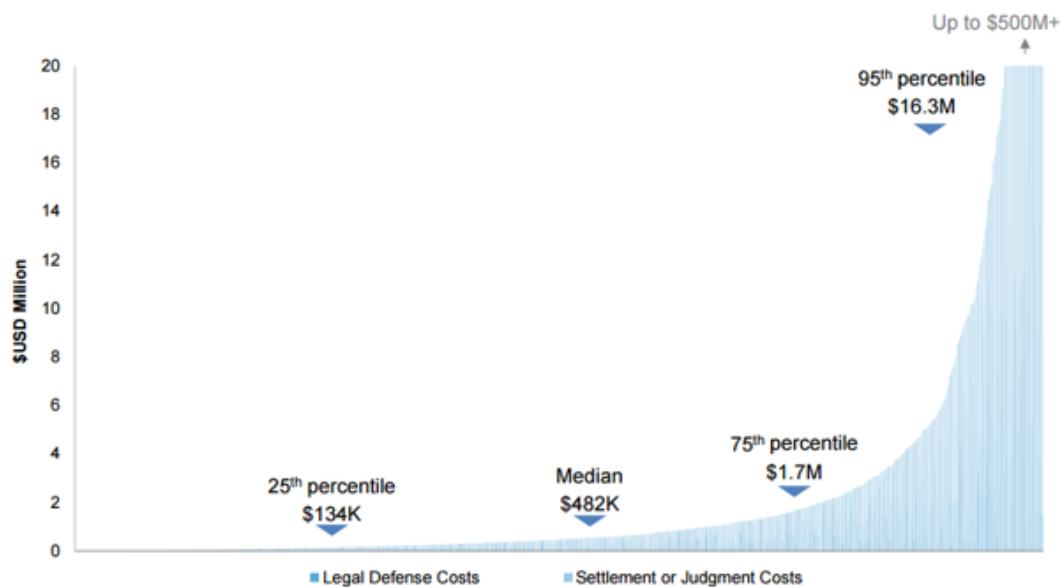
Until recently.

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"Patent trolling" rapidly became infamous in the 2000s. Patent trolls, as they are pejoratively named, discovered that they could purchase a portfolio of patents, initiate lawsuits on the basis on patent infringement, and pocket the settlement offered by the defendant. Typically, the patent troll purchases patent from financially-distressed companies, thus allowing the patent troll to acquire intellectual property at cheap prices, due to the presence of a cash-strapped and highly motivated seller. This practice was highly lucrative resulting in a flood of patent trolls adopting a similar modus operandi. Suffice to say, as the number of patent trolls increased, patents became more expensive. Regardless, the practice remains feasible from a financial standpoint.

Wide Distribution of Resolution Costs

Cost to Resolve an NPE Suit



Source: RPX Research. RPX NPE Cost Report 2014

Although successful infringement lawsuits are few and far between, the outsized payout (as seen in the above) from a single lawsuit continued to motivate patent trolls. Companies began to suffer from lawsuits initiated by patent troll. Most notably, Apple (NASDAQ:AAPL) is the #1 target for patent trolls, having received over a hundred lawsuits in recent years. Patent trolling is clearly a big problem.

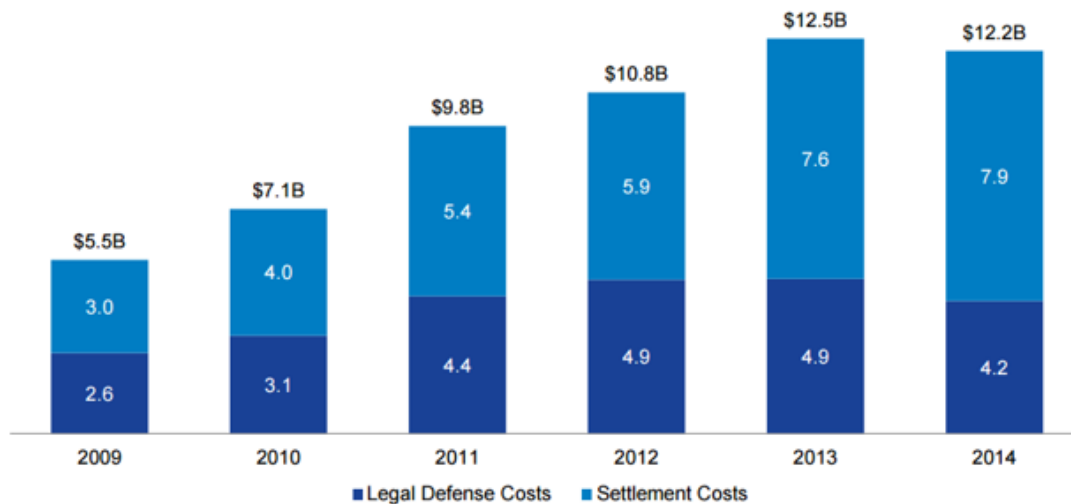
The curious reader would probably have the following question in mind: can't companies defend against these lawsuits? To that question, the answer is a resoundingly yes.

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management from their core operations. Additionally, settlement costs are equally huge. Combined, legal defense and settlements costs to the industry have grown from \$5.5b in 2009 to \$12.2b in 2014 (as seen below).

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Estimated NPE Cost to Industry



Methodology notes: Costs from NPE litigation calculated from average legal and settlement costs, multiplied by total NPE litigation volumes. An additional gross-up is added to account for NPE-related costs outside of litigation (e.g. NPE assertions not proceeding to trial, IPR / re-exam proceedings, etc.)
Source: RPX Research. RPX NPE Cost Report 2014

Furthermore, the defendant is in no position to counter-sue, given that the plaintiff (patent troll) typically does not create or sell their own products and services. Hence, there is no legal basis for a countersuit.

RPX Corporation (NASDAQ:RPXC) offers a solution.

Enter RPX Corporation

The company's business model is rather simple to understand. RPXC offers two solutions:

- a defensive patent aggregation solution,
- and insurance to cover the costs of patent litigation.

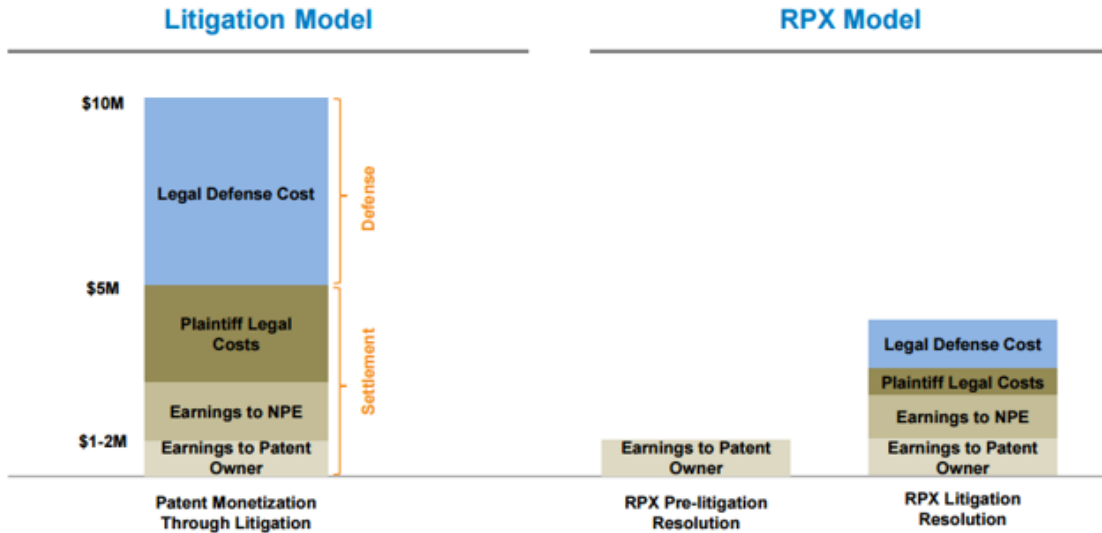
Simply put, RPXC first acquires a portfolio of patents (thus aggregating them) and then provides their clients with licenses to these patent assets, hence protecting said clients from potential litigation exposure. In a nutshell, the company acts as a middleman

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between its clients and patents. Additionally, the company also offers patent litigation insurance, which serves as a natural add-on to its core patent risk management solution.

A Rational Alternative to Market Inefficiency

Illustrative Transactions

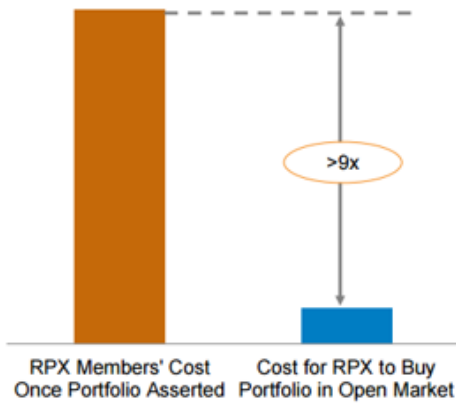


Source: RPX Corporation

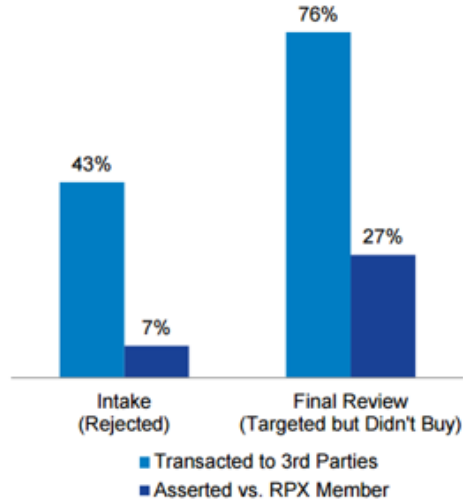
The firm's core patent risk management solution is a tremendous value-add to its clients. The rationale here is simple. Essentially, RPXC helps its clients dramatically reduce the cost of patent litigation. The patent market is highly irrational due to the presence of huge deadweight losses (primarily legal costs). Non-practicing entities ("NPEs", a more palatable term for patent trolls) use litigation to transfer value between patent owners and users. Litigation costs are substantial.

Pre-litigation Acquisition 9x More Efficient

Open Market Clearance Highly Efficient¹



...and RPX Can ID High-risk Portfolios²



Source: RPX Corporation

Litigation Acquisition ~3x More Efficient

Cost per dismissal (\$000s)



Source: RPX Corporation

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