

les Nouvelles

JOURNAL OF THE LICENSING EXECUTIVES SOCIETY INTERNATIONAL



Advancing the Business of Intellectual Property Globally



The Startup IP Playbook: Leveraging IP For Funding, Growth And Exit

By Efrat Kasznik

Do Startups Need Patents?— The Unicorn Dilemma

In 2015, Instacart was already a successful U.S.-based Unicorn (a Unicorn is defined as a pre-exit startup with valuation in excess of \$1 billion). At the time, Instacart had a valuation of \$2 billion, and had already raised more than \$250 million in funding. It also had no published patent filings, neither pending nor issued. Another member of the U.S.-based Unicorn cohort of 2015, GitHub, also had a valuation of \$2 billion, and raised \$350 million in funding. GitHub had no published U.S. patent filings either (pending or issued), nor did 26 additional U.S. Unicorns in 2015. As a matter of fact, as seen in Figure 1(a), a *study conducted in 2015 by Foresight Valuation Group* found that 30 percent of all U.S. Unicorns in 2015 had no published U.S. filings (pending or issued),¹ and another 32 percent had less than 10 assets assigned to them. All in all, over 60 percent of U.S. Unicorns did not have a significant patent position (defined as 10 or less published U.S. filings, either pending or issued). And yet, these Unicorns, as of 2015 have raised, on average, a total of \$495 million in funding with a median valuation of \$1.3 billion, and many of them went on to have a successful exit, either by M&A or through an initial public offering (IPO). This “patent gap” has been getting even wider in a follow-up study of Unicorns conducted in 2022, where 41 percent of all U.S. Unicorns in 2022 had no published U.S. filings (pending or issued), and close to 70 percent of the U.S. Unicorns fell in the 10 and under asset portfolio category. One important observation that will come up later in this article is related to the industries that the unicorns operate in. As seen in Figure 1(b), the vast majority of the Unicorns operate in Software-related industries. When adding up the following segments in

the pie chart: Software, Advertising, Consumer Internet, E-commerce, Education, Enterprise SaaS, Financial Services, and Security, that combined percentage is close to 80 percent. See Figure 1(a) and 1(b) on page 68.

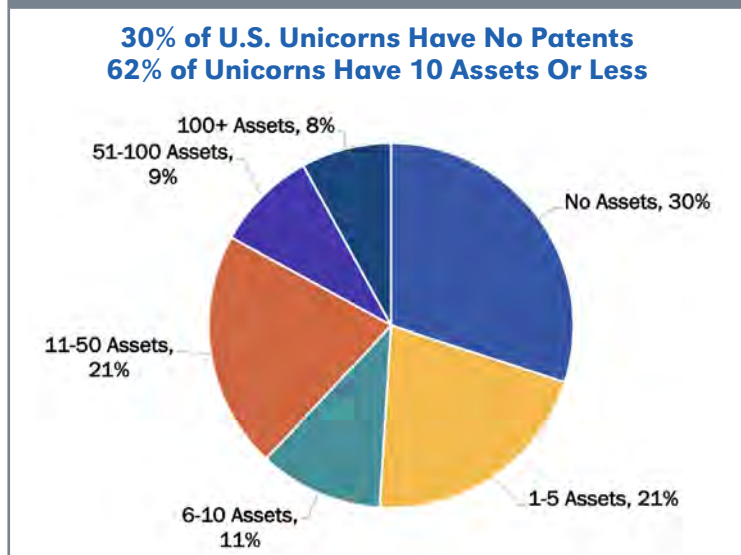
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The 2015 Unicorn study focuses on one group of startups, the most valuable (and arguably, successful) ones, and seemingly shows a lack of correlation between patents and startup valuation (*e.g.*, you can reach a billion-dollar valuation without filing any patents). There can be several plausible explanations for this phenomenon, which have been thoroughly explored in a *previous article*. One of the issues in drawing any conclusions from the Unicorn study is that it looks at a snapshot in time. Another issue with trying to correlate IP position and startup valuations is the “one size fits all” approach that we often find with founders and investors alike. To truly understand how IP plays a role in startup success, one needs to look at the trajectory of a startup’s lifecycle, from funding to exit. One also needs to look at the startup’s business model, as well as the investment goals of its investors, and how IP plays a role in helping both sides achieve their goals. The intersection of the startup’s lifecycle, its success metrics, and its IP strategy may help shed a light as to why Unicorns reach billions of dollars in valuation while having no patents, while at the same time other startups must have a significant patent portfolio before they even release a product in the market.

This article will lay the foundation for an IP management paradigm for startups that substitutes the one size fits all approach with a smarter, more nuanced IP strategy that could help leverage IP more optimally for startup success. It should be noted that this article focuses primarily on patents, which is an asset class most investors and founders are focused on. Having said that, patents are only one portion of an IP strategy, and the guidelines provided in this article could be carried forward to other IP assets, such as trade secrets, trademarks (brands) and copyrights.

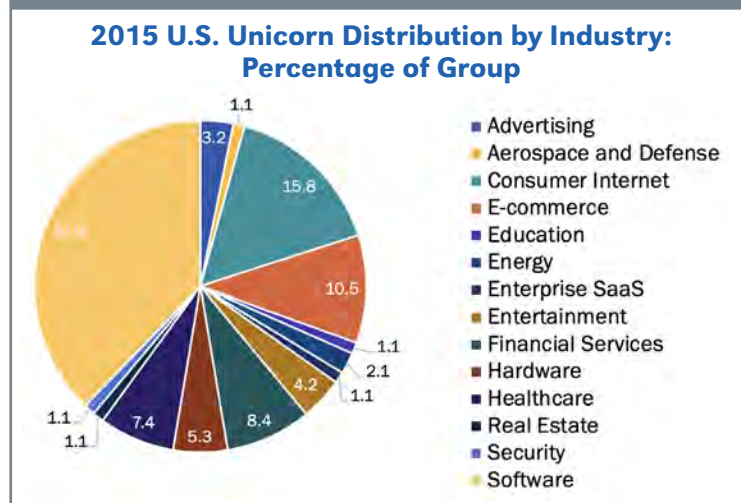
1. It should be noted that the Unicorn study, as well as this article, are focused on patent ownership, which is a publicly available metric that can be objectively compared across companies. The Unicorn study was conducted using commercially available patent analytics tools that are based on the USPTO patent database. Patent analytics tools usually adjust for corporate name variations, ownership transfers and other potential discrepancies with ownership data. The Unicorn study did not consider exclusive license agreements as a substitute for patent ownership; while license agreements may be a way to incorporate IP in a product, these are not fully disclosed publicly and do not convey the same benefits as patent ownership.

Figure 1(a): 2015 Unicorn Study: 30% Of U.S. Unicorns Have No Patent Assets



Source: Foresight Valuation Group LLC, 2015 Unicorn Study

Figure 1(b): 2015 Unicorn Study: U.S. Unicorn Distribution By Industry



Source: Foresight Valuation Group LLC, 2015 Unicorn Study

Too Much or Too Little? Startups are Often Misguided When It Comes to IP Strategy

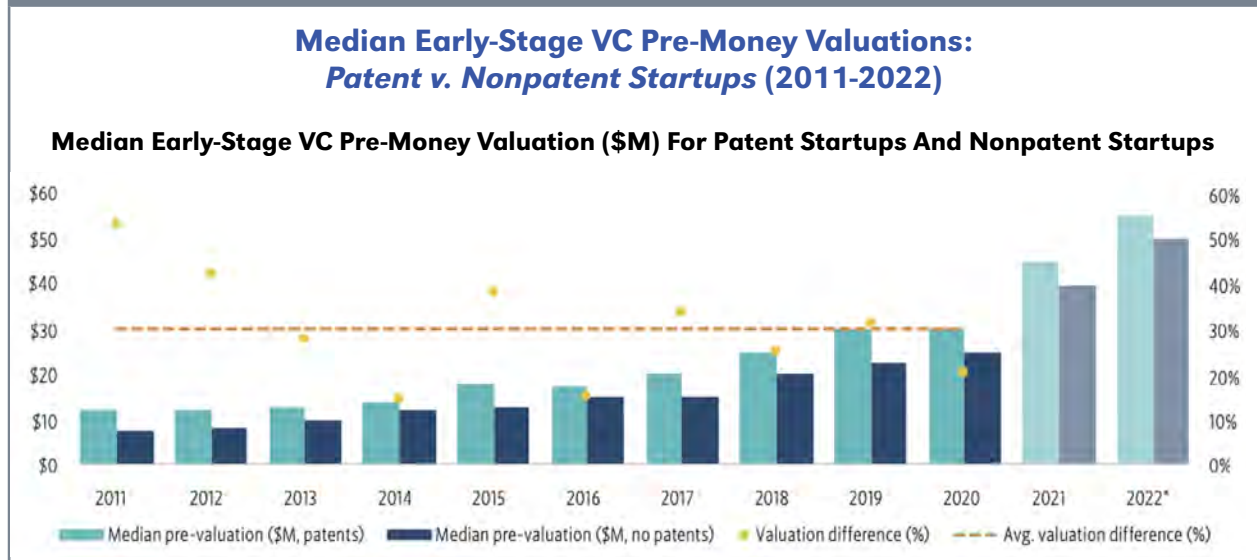
The relationship between intellectual property rights, such as patents, and startup success is one of the most poorly understood areas in the field of IP management. It is misunderstood by founders, as well as by their investors, who are the ones often controlling spending in a startup. The lack of robust, empirical evidence as to the relationship between IP and startup valuation cre-

ates fertile ground for mismanagement of one of the most critical assets that a startup possesses. Take, for example, a recent study conducted by PitchBook, a prominent provider of startup funding and valuation data. PitchBook has recently added patent data to its service offerings, and in a February 2023 article titled *“PitchBook Analyst Note: Introducing PitchBook Patent Research,”* presented the findings from quantitative research on the correlation between patent positions and startup funding and valuation. In its overview of the study design, PitchBook states: *“This analysis does not make a distinction between firms with granted patents and those with pending patent applications. For our analysis, companies that have granted patents or pending patent applications at the time of a venture funding round or exit are included in the group and referred to as “patent companies,” “patent startups,” or the “patent set.”* It then continues to present side-by-side comparisons of the patent and nonpatent startups, such as in Figure 2 on page 69.

This chart seemingly shows a higher median pre-money valuation (the valuation of a startup before funding money comes in) of *Patent v. Nonpatent* startups, which is trending on average at a 30 percent premium. However, this conclusion is not properly substantiated: since the inclusion threshold for a “patent company” is so low (at least one pending or issued patent), the significance of having patents as a valuation factor is questionable; the higher valuations for “patent companies” may be attributed to other explaining factors correlated with patents, for example: novel technology resulting in more users, which makes the idea patentable but does not make the patent the reason for funding. The study should have increased the inclusion criteria threshold to make patent holdings a meaningful variable (as opposed to an incidental observation), while at the same time controlling for other variables that may be correlated with the mere filing of patents.

It is no surprise, then, that with conflicting evidence, ranging from Unicorns that have no patents to the PitchBook study showing a high correlation between patents and valuations, startups are often misguided when it comes to pursuing an IP strategy. On the one hand, there are those who presume that every startup needs to

Figure 2: PitchBook Patent v. Nonpatent Pre-money Valuations (Dec. 31, 2022)



Source: PitchBook | Geography: US
 *As of December 31, 2022

have patents to secure funding and reach a successful exit. As a result, you may see a startup like the software company we recently encountered while working on a bankruptcy case, which had over 200 patents, distributed across every possible country in the world (at least one in each country where filing patents is possible), but still could not execute on its business model and had to file for bankruptcy. On the other hand, there are those, many investors included, who believe that securing IP rights diverts valuable resources from building a product and securing customers. This leads to the Unicorn phenomenon: a startup that achieves billions of dollars of valuation with no patents at all.

The Three Pillars of Startup Success: Execution, Funding and Exit

To untangle the relationship between IP strategy and startup success, we first need to define what a startup is, how a startup transitions throughout its funding cycle, and what are the elements of startup success. The discussion below addresses these questions, while also outlining the Venture Capital (VC) investor’s business model and how it plays a key role in the definition of startup success.

What is a Startup?—Steve Blank, a Silicon Valley startup guru, known as the “Father of Modern Entrepreneurship,” has defined a “startup” in his seminal 2010 blog post, “*What’s A Startup? First Principles*,” as follows: “A startup is an organization formed to search for a repeatable and scalable business model.” I find the Blank definition particularly useful, as it focuses, not on

size or valuation, but on the most important element in a startup’s journey: its business model execution.

The Startup Funding Cycle—With the focus on finding the right business model, most startups are not profitable nor self-sustainable in the early years, and sometimes they do not reach financial stability up until their point of exit. To be able to operate, most startups need outside funding. Startup funding comes in various forms: Equity (investment in return for stock ownership), Debt (interest-bearing loans), or some hybrid debt/equity instruments (such as convertible notes). Equity is the most common source of startup funding, from the early to the late stages; debt is usually more common in later stages, when companies either have operating cash flows to service the debt or have assets to collateralize. Funding is critical to the survival of many startups, particularly pre-revenue ones or those operating in R&D-intensive industries, such as Biotech.

The VC Business Model—Startup equity funding can come from different sources, depending on the stage in the startup’s lifecycle. In the early stage, before the startup has achieved an indication of product-market fit, funding usually comes from friends and family or from angel investors (individuals investing their own money). As startups mature, they get into the zone where they qualify for fund investors (Series A and above), and the most common group of investors are VC investors (in later stages, there are also private equity and corporate venture investors, in addition to more debt funding).

VC investors are working as fund managers, raising

funds from investors which they manage and investing in high-risk, high-return investment opportunities. Due to the high failure rate of venture investment (it is commonly assumed that over 90 percent of all VC investments fail), VC's use portfolio investment as a hedging strategy. Each portfolio company must have the potential for a 10-fold return to make up for the losses resulting from the other companies in the portfolio. To ensure this high level of return potential, VC portfolio investments are usually focused on startups addressing well-known problems in very large markets (a business strategy known as: “problem looking for a solution”).

As seen in Figure 3, VC activity in the U.S. has grown almost 11 times over the last 11 years, from \$32.4 billion in 2010 to \$345.3 billion in 2021, dropping to around \$240 billion in 2022 (primarily due to the increase in interest rates). The number of U.S. VC deals in 2021 was roughly 18,626, which is 3.3 times the number of deals in 2010 (5,616). Since the growth in dollars invested outpaced the growth in number of deals, we can observe from this chart that the average VC-backed deal size in the U.S. has grown from \$5.8 million in 2010 to \$18.5 million in 2021.

As seen in Figure 4, on page 71, VC Investment is concentrated in industries with the highest return per dollar invested in the shortest period of time—like software, which is the industry with the best match for the VC business model. As previously discussed, over 80 percent of the Unicorns included in the study shown in Figure 1(a) are software companies (including in-

dustries such as enterprise software, fintech, cybersecurity, advertising, and others). VC investment is not as suitable for long R&D projects requiring very high investments over long periods of time (hence the lower concentration of VC investment in life sciences). VCs invest relatively smaller amounts in return for minority positions and aim for an exit event within five to seven years on average.

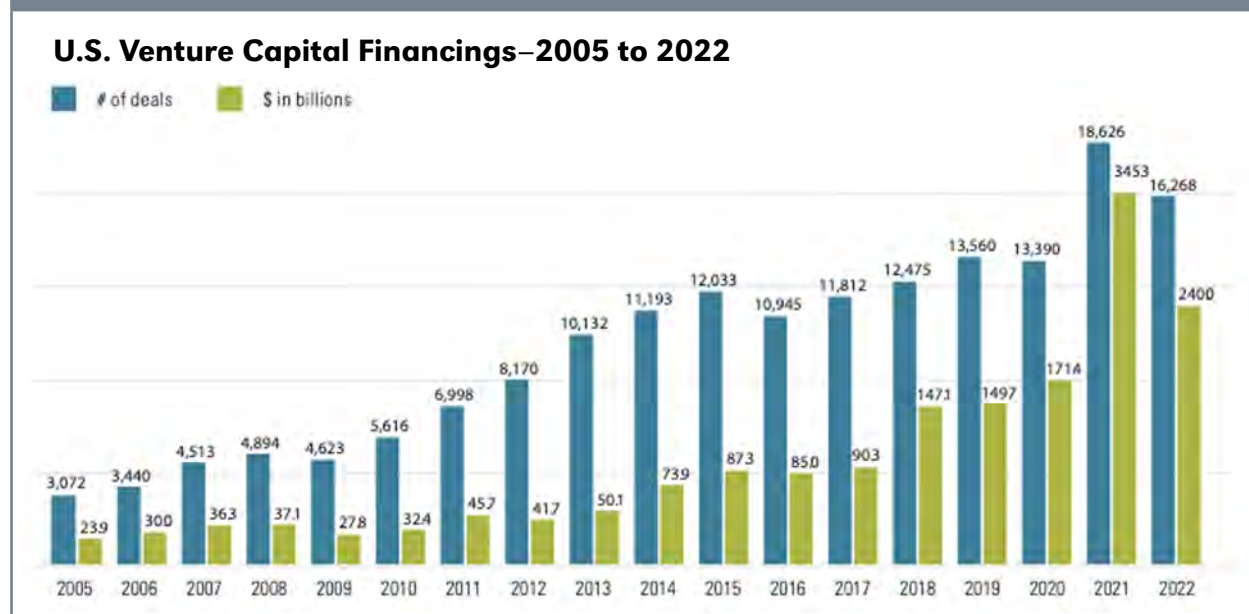
Finally, a venture-funded startup must have an exit to provide liquidity for the VC investors, as well as for the founders. Most startups exit by mergers & acquisitions (M&A); the other type of exit, IPOs, are not as common, particularly in high tech (more common in life sciences). We will come back to the topic of exits later in this article.

The Three Pillars of Startup Success

Based on the foregoing, the measurement of the VC-backed startup success comprises the following three pillars:

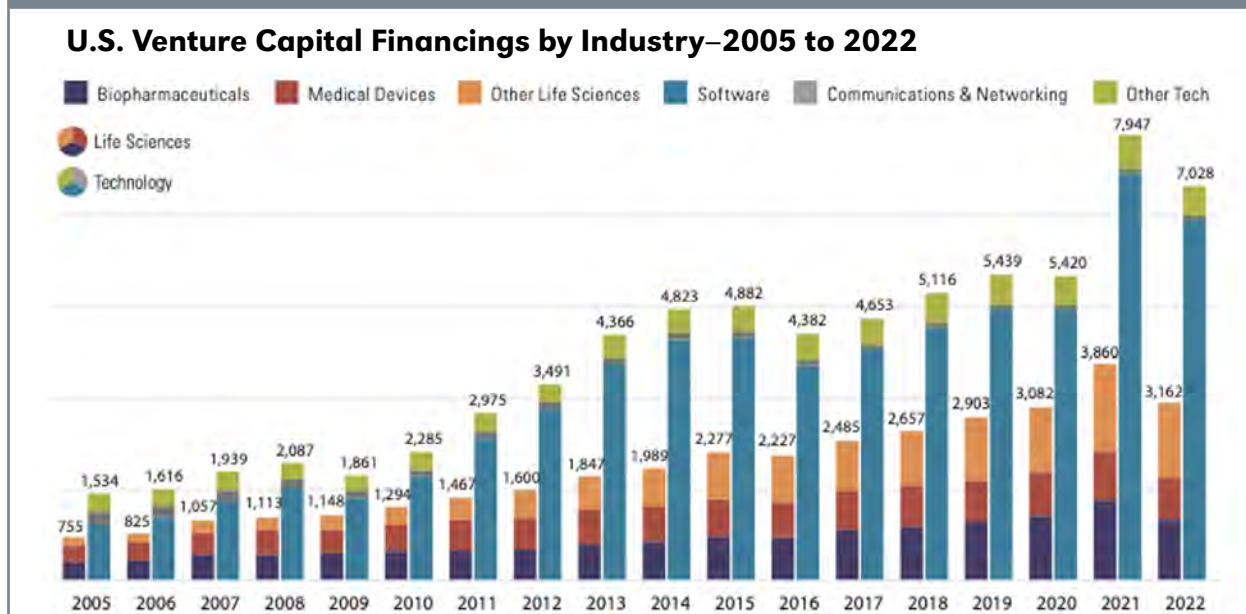
1. **Business Model Execution**—following the Blank definition, a startup should be focused on finding a business model that can be executed repeatedly and profitably. This is a primary condition for obtaining the other two pillars: funding and exit.
2. **Funding and Growth**—funding is critical for the VC-backed startup's survival and growth, and the ability to fundraise (often more than once) is the second pillar of success.

Figure 3: U.S. Venture Capital Funding: 2005 To 2022 (All Rounds)



Source: PitchBook

Figure 4. U.S. Venture Capital Funding: 2005 To 2022 (All Rounds)



Source: PitchBook

3. **Exit**—every VC-backed startup must have an exit to provide liquidity and return on investment. Since over 90 percent of VC-backed startups fail to get to an exit, this pillar is the most difficult one to obtain (a startup can obtain success in pillars 1 and 2, but still fail to get to an exit, which happens very frequently).

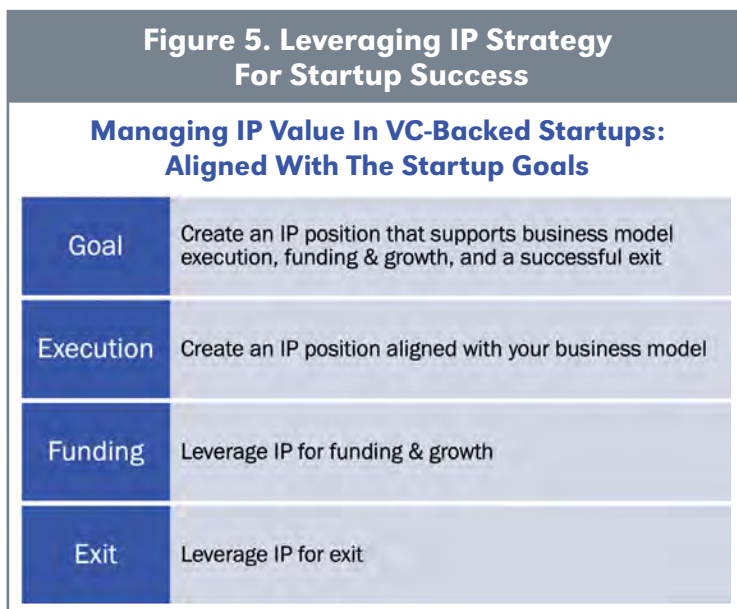
making it a more desirable target and by allowing it to negotiate a better price.

Figure 6, on page 72, presents a schematic diagram that can be used for a high-level understanding of the types of business models that most VC-backed startups fall under, by segmenting them into three major categories. There are several ways to classify business models, but this particular scheme is presented here since it results in classifications that have the most impact on

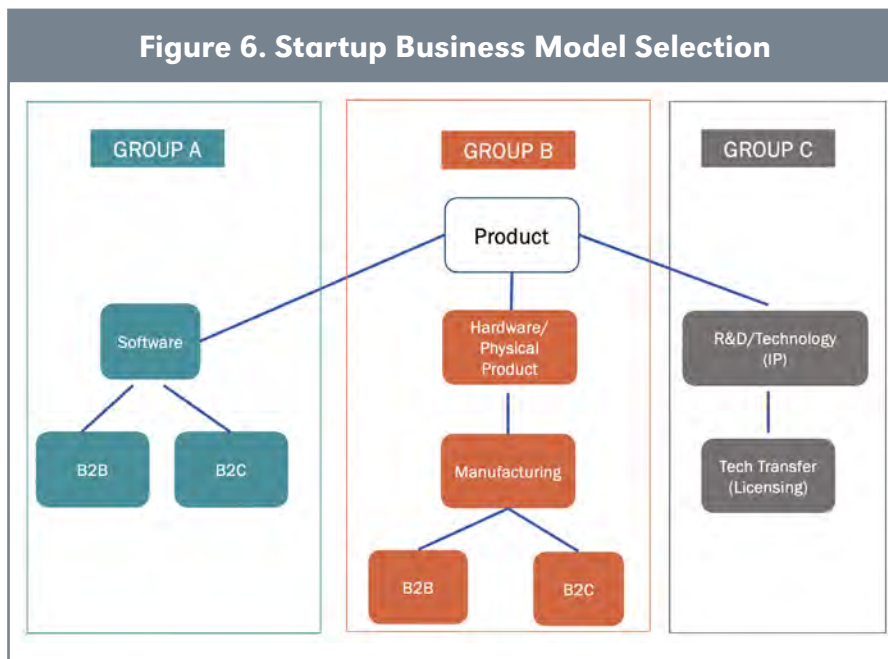
One Size Does Not Fit All: Aligning IP Strategy with the Startup’s Business Model

Building upon the three pillars of startup success— execution, funding, and exit—we turn next to discuss how IP strategy is supporting these goals. The rule of thumb with creating an IP position in a VC-backed startup should be very simple: **create an IP position that supports business model execution, funding and growth, and a successful exit.** This guideline applies to each of the three pillars, as shown in Figure 5.

Going back to the Blank definition, business model execution is what defines a startup, and it also impacts all three of these pillars. An IP strategy that is properly aligned with a business model will lead to better execution and will create an IP position that could be leveraged for funding and growth. A properly aligned IP position can also increase the startup’s chances of having a successful exit by



Source: Foresight Valuation Group LLC



Source: Foresight Valuation Group LLC

IP strategy. The key to the classification presented here is the **type of product** the startup is developing, of which there are three:

- Group A: Software Products**—the product is based on digital components, with no physical elements; these companies could further have two types of markets: business-to-business (B2B), and business-to-consumer (B2C).
- Group B: Hardware/Physical Products**—there is a physical embodiment of the product (it can include software as well, so there could be hybrids of Group A and Group B), and there is some manufacturing involved; these companies could further have two types of markets: B2B and B2C.
- Group C: R&D/Technology Product**—these are research companies where IP is the product. These companies are using technology transfer (via licensing or sale) to commercialize the product. The commercialization is usually done through businesses (B2B) who productize the IP, so there is not much of a B2C market in this category.

We turn next to discuss each of these categories and its IP consideration in greater detail in the next section.

Doing It Right: Leveraging IP Strategy for Startup Success

1. Group A: Software Startups

The VC business model is skewed towards investment in software companies (as demonstrated by Figure 4, as well as by the Unicorn study). This product

type offers the best fit for the VC investment goals, as companies can grow significantly with relatively low investment (as compared with more R&D-intensive industries), over the shortest period of time. As seen in Figure 7 below, software companies focus on products such as: services marketplace (Airbnb), fintech (Square) and social media (Meta). In its purest form, a software product has no physical embodiment, and therefore there is no manufacturing required; product delivery is done digitally, and there are several business models depending on the service being B2B (enterprise software, usually sold via software-as-a-service subscription, known as SaaS) or B2C (user access is usually free, and the service is funded by advertising).

Software startups tend to focus on patents later in their lifecycle, after launching a product and acquiring users. While this might sound counter-intuitive to some of our readers, the facts speak for themselves. IP strategy needs to serve the three pillars of success, and patents are not critical to obtaining users, which are the most important key performance indicator (KPI) impacting the valuation and success of a software company. As a matter of fact, some pre-revenue software startups have been acquired based on users alone, for example: *Instagram was acquired for \$1 billion by Facebook in 2011*, with about 50 million users and no revenues (and no patents, either). The 2015 Unicorns are the strongest evidence of software companies not needing patents to get to billions of dollars in valuation, as over 80 percent of them are software companies. As previously mentioned, the median U.S. Unicorn valuation in 2015 was \$1.3 billion, and over 60 percent of them had no significant patent holdings (10 or less assets).

The main reason for the lack of focus on patents until later in the lifecycle of a software company is related to the **alignment of IP protections** with assets: the main asset developed by a software company, its software platform, is not very well protected by patents. Patents covering software-related inventions have been fraught with issues in the U.S. over the past decade, with judicial and legislative decisions causing confusion regarding subject matter eligibility, with the Patent Trial and Appeal Board (PTAB) causing uncertainty related

to validity, and with new challenges emerging around artificial intelligence (AI) inventorship issues. Brand is another important IP asset for both B2B and B2C software companies, but the main legal IP protection there are trademarks, not patents.

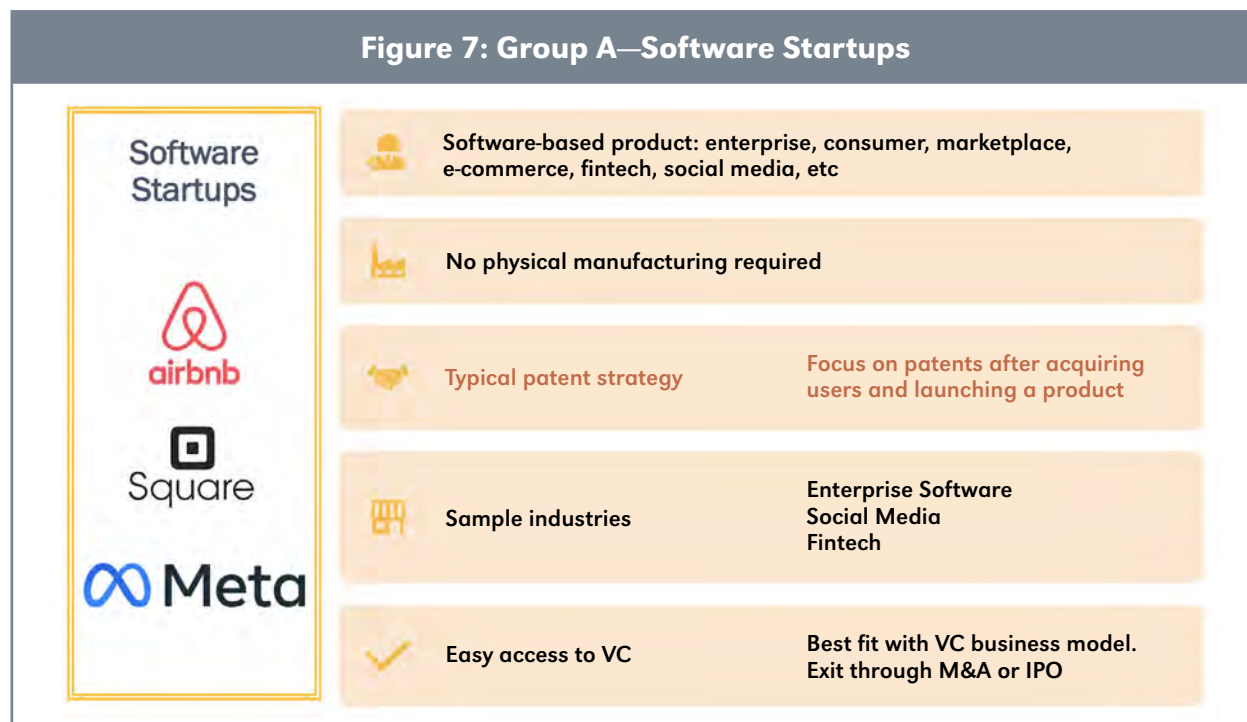
All the above is not to say that software startups do not need patents to succeed. **A deeper look at patent strategies of software companies is showing a “coming of age” when it comes to patents**, as software companies catch up on their patent holdings as they mature and approach critical inflection points in their journey, such as entering new markets or approaching an exit event. That makes sense and is consistent with the rule of thumb that IP strategy in a startup should serve the three pillars of success: with software companies, it is usually the case that strengthening their patent position is needed at the later stages of executing their business model, usually to ensure freedom to operate or enter new markets (first pillar), or to ensure a smooth path to exit (third pillar). The second pillar—funding and growth—is not as closely aligned with patents in a software company as it is in Group B or Group C companies, as we will see in the following sections.

One common situation can shed some light on the possible threats to software startups’ business model execution at critical inflection points, particularly as it relates to their exit (third pillar of success). Patent lawsuits against startups on the eve of their IPO have

been a common strategy by competitors and other patent holders, to put pressure on a startup and force a license or an acquisition of the patents subject to the lawsuit. At this juncture, a startup is most vulnerable, and one thing it can try to do is fight back by counter-suing, but to do that, it needs to have its own patents and particularly ones that the plaintiff suing might be infringing. One such pre-IPO lawsuit was *brought against Facebook in March 2012* on the eve of its IPO by Yahoo. Facebook reportedly only had 56 patents in early 2012 and ended up spending over \$550 million buying over 1,400 patents from Microsoft and IBM to strengthen its patent position so it could, among other things, counter-sue Yahoo. Fast forward 12 years, and pre-IPO patent infringement threats are still present for software startups; in March 2024 *Nokia sent a demand letter to Reddit* a few days before its scheduled IPO, where it alleges potential infringement of one of its patents. See Figure 7.

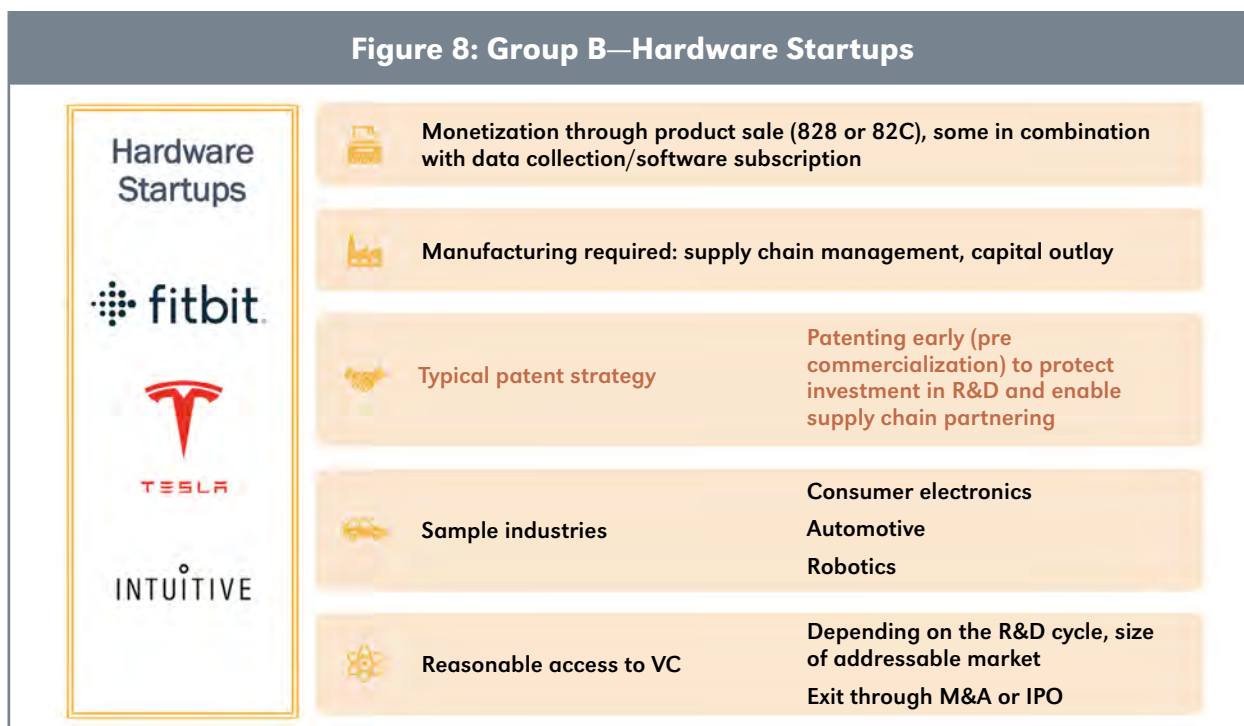
2. Group B: Hardware Startups

Hardware startups create physical products, where there is a manufacturing element to the product. As seen in Figure 8 below, some of the common hardware segments that VCs invest in include: wearable consumer electronics (Fitbit), automotive (Tesla) and robotics (Intuitive). While hardware devices do not necessarily need to have a software component, many devices made today, whether consumer electronics or industrial equipment, are connected devices: they are equipped



Source: Foresight Valuation Group LLC

Figure 8: Group B—Hardware Startups



Source: Foresight Valuation Group LLC

with sensors that collect data that is transferred and processed in the cloud. The revenue model is based on product sales, but often includes data analytics and/or software subscriptions associated with the device. The field of connected devices is generally known as the Internet of Things (IoT), an area where VCs are very actively involved. Another large area of VC investment that falls under the hardware category, on the life sciences side, is medical devices.

When it comes to IP strategy, and patents in particular, there are several considerations that make patenting more prevalent in hardware startups from the very early stages. The threat of infringement is much higher in physical products, since reverse engineering is easier with a product that is tangible, and therefore patents serve as an important exclusionary barrier to competition. There is often significant R&D involved in physical product development, testing and commercialization, including safety testing and other steps that a software product does not need to go through. Patents traditionally go hand-in-hand with high R&D dollars, as the investing company likes to secure the IP rights associated with the investment. Startups in automotive, robotics, medical devices, and similar industries usually have significant patent holdings as an integral part of their business strategy. In addition, due to the nature of these products, they often include a convergence of several technologies, which makes it incumbent to engage in licensing and technology transfer to incorporate all the necessary com-

ponents. Hardware products are also frequently subject to technology standards, where patents play a key role.

Going back to the Unicorn class of 2015, while the hardware segment accounts for less than 5 percent of the group (some hardware companies are classified as Hardware, while others are classified under other industries like Energy and Healthcare), they account for half of the top 10 patent holders. The top 10 patent holder list includes the following hardware Unicorns, with their respective valuation and portfolio sizes as of 2015: Bloom Energy (\$2.83 billion, 211 assets), Magic Leap (\$2.04 billion, 134 assets) and Square (\$6 billion, 150 assets). Both Square and Bloom went on to have successful IPOs in 2015 and 2022, respectively. Magic Leap is still private, but has leveraged its patents for funding by *pledging its IP portfolio of close to 2,000 patents against a loan from JP Morgan in 2019.*

When it comes to the three pillars of startup success, the hardware business model is very well suited for leveraging patents for success. Below are a few examples from hardware startups that we have worked with, who managed to leverage their patent portfolio across all three pillars:

- **Business model execution**—many startups in this category spend several years in R&D to develop a product, and in parallel they work on their patent portfolio to align it with the product launch so that they have a strong patent position around the product when it is launched in the

market. We have seen this strategy play out with startups in industries as diverse as aviation (new aircraft design), energy (novel data center cooling technology) and robotics (telepresence robot), to name a few.

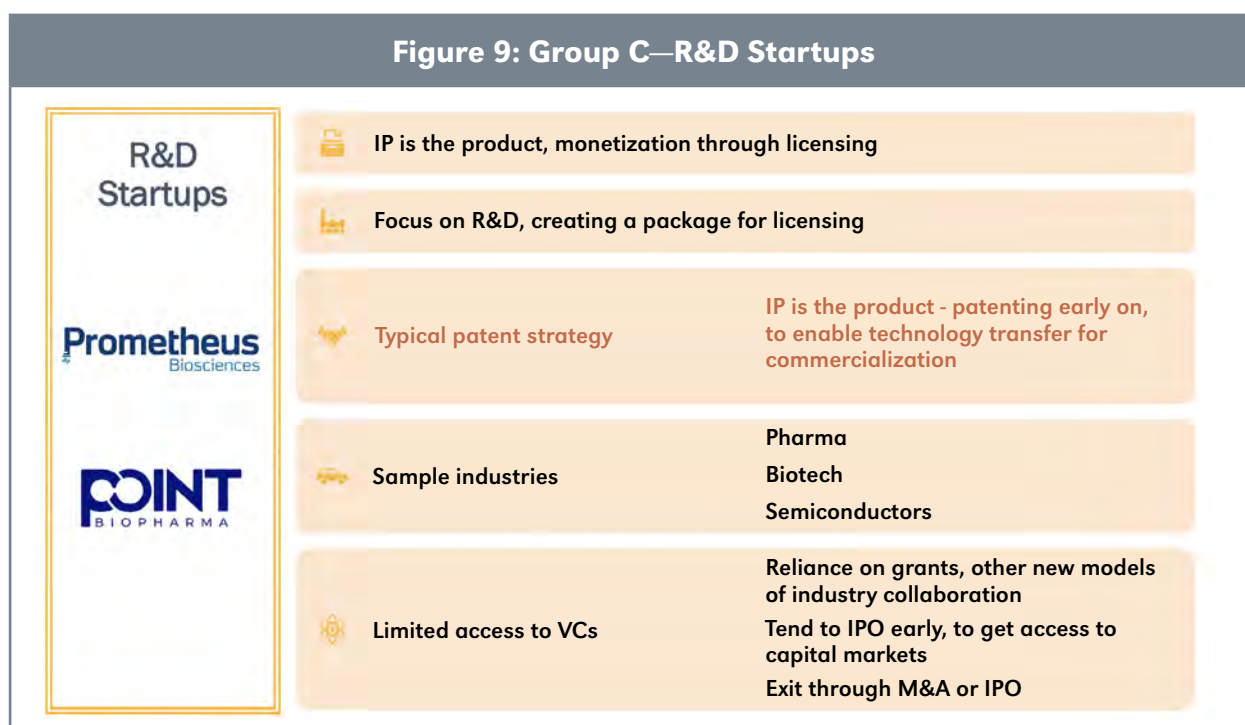
- **Funding**—the energy startup developing new water-based cooling technology for data centers spent over two years creating its patent portfolio, while at the same time working on a prototype. To fully build the prototype, it needed over \$15 million in funding (Series A) and managed to successfully leverage its patent portfolio (including pending and issued patents in several jurisdictions) to raise both equity and debt funding from VC investors.
- **Exit**—another startup we have worked with in the telecom space has managed to negotiate a higher acquisition price based on its patent portfolio. The company's patent portfolio covered antenna technology that had significant licensing opportunities outside its core business. The original acquisition price did not include the non-core licensing potential of the patent portfolio, but the company conducted a separate valuation to determine the value of the portfolio based on the additional revenue streams enabled for the buyer. Based on that valuation, the company managed to negotiate a higher acquisition price. See Figure 8.

3. Group C: R&D Startups

A few years ago, I was engaged as a valuation expert

in a post-M&A legal dispute involving the acquisition of a nucleic acid diagnostics startup by one of the largest pharma multinationals. The startup target was in clinical stages of product development. The acquisition was structured along milestone payments, which is not unusual with M&A deals, except the milestone in this deal was determined based on the issuance of a patent, with additional payment determined by the final scope of the patented claims. The company had one pending patent that the acquirer was keen on in particular, so much so that half the acquisition price was predicated on the issuance of that patent with very specific claim language. What transpired next was that the patent did issue but with modified language, which led to a legal dispute as the buyer refused to pay the milestone. This story is a very good introduction to Group C: R&D companies, where IP is the product.

R&D companies are developing technology to transfer to others for commercialization. The IP is held by one company, and the product is made by another. As seen in Figure 9 below, this business model lends itself to industries like semiconductors, biotech and pharma. The focus is entirely on developing technology and getting it ready for licensing, with a strong focus on IP rights to enable licensing or to attract a larger buyer. This business model requires significant investment in R&D over a long period of time. The characteristics of this business model make it the exact opposite of what a typical VC is looking for. While there are some VCs who specialize in life sciences or semiconductors, there



Source: Foresight Valuation Group LLC

are many more VCs who invest in software startups, as shown in Figure 4. Due to the limited access to VC funding, and the high capital investment required, life sciences startups in the biotech and pharma areas tend to IPO early to get access to capital markets. These are smaller IPOs, and most of these companies are still undergoing product development or are in the process of obtaining FDA approvals. These companies will rarely become Unicorns, and that is why their percentage of the Unicorn sample is negligible.

Figure 9 shows examples of multi-billion biotech startup exits in the pre-revenue stage (both had IPOs prior to the acquisition and were acquired as public companies, although the acquisitions can be counted as the main exit event):

- Prometheus, a clinical stage company, was *acquired by Merck for \$10.2 Billion in 2022*, at a 75 percent premium over its stock price at the time of the offer.
- Point Biopharma, a company with a pipeline of clinical and preclinical-stage therapies, was *acquired by Eli Lilly for \$1.4 Billion in 2023*.

The story of Prometheus is indicative of how R&D startups get acquired primarily due to their IP. Merck Chief Executive, Robert Davis, *cited the Prometheus long patent life* as one of the main reasons for the acquisition: "This is allowing us to move into immunology in a strong way and will allow us sustainable growth, we think, well into the 2030s given the long patent life."

New Business Models on the Horizon—What about AI?

In closing, this article covered the three types of startup business models, and how each of these relies on

patents to advance business model execution, funding, and exit. The savvy founder and/or investor should apply an IP strategy that is guided by their venture's underlying business model, as opposed to a one size fits all approach (either patent at all costs, or don't patent at all). Looking forward, business models are becoming more complex with the proliferation of AI. As startup funding pours into AI companies, the old software business model—the one that required very little focus on patents—is not going to be sustainable anymore, as much more hardware will be required (either in sensing equipment or in computing equipment) so AI startups will be moving into Group B (Hardware), as opposed to being pure Group A (software) companies. Additionally, the investment requirements of AI companies are enormous, more in line with large R&D projects and less in line with the typical VC software investment. As a result, we are already seeing a change in investor profile, as more corporate investors are entering startup investment, like Microsoft investing billions of dollars in OpenAI. Many of these large corporations have a better appreciation of patents and other IP rights than a typical VC would have. It is our prediction that these AI-driven forces will work to elevate the importance of patents and other IP rights in executing startup business models and in driving startup valuations. ■

**This article covers a portion of the curriculum taught in the newly-created LES USA & Canada professional development class: "Managing IP Value in Startups and Emerging Ventures." The course is largely based on the author's class at the Stanford Graduate School of Business, titled: "Intellectual Property: Financial and Strategic Management," as well as on the author's experience of over 25 years as a Silicon Valley-based IP and startup valuation and strategy expert.*