Title
Dollars for Genes: Revenue Generation by the California Institute for Regenerative Medicine

Permalink
https://escholarship.org/uc/item/5dt9h0p3

Author
Gilbert, Richard J

Publication Date
2006-06-01
Dollars For Genes: Revenue Generation by the California Institute for Regenerative Medicine

Richard Gilbert*
June 2006

I. Introduction

Human embryonic stem cell research promises potential breakthrough therapies for diseases such as Alzheimer’s and Parkinson’s, spinal cord injuries, cancer, HIV/AIDS, multiple sclerosis, heart disease and mental health disorders.1 In November 2004 California voters passed Proposition 71, the initiative that created the California Institute for Regenerative Medicine (CIRM) and authorized the state to issue up to $3 billion in general obligation bonds to fund human embryonic stem cell research and provide overhead for the Institute.2 In addition to the potential for stem cell research to improve lives, some supporters of Proposition 71 also promised large royalty income from the licensing of new technologies that would result from CIRM-funded research.3 A study prepared by Laurence Baker, Professor of Health Research and Policy at Stanford University, and Bruce Deal of Analysis Group (“Baker-Deal report”) predicted that the State would earn from $537 million to $1.1 billion in royalties from research funded by Proposition 71.4

This paper derives a much lower estimate of likely licensing income from CIRM-funded R&D. My methodology refines the approach in the Baker-Deal study and also forecasts

---

* Professor of Economics, University of California at Berkeley.
future licensing income based on an evaluation of historical licensing income from sponsored research at Universities, hospitals and research institutes. My best estimate of licensing income is only a few percent of expenditures on human embryonic stem cell research and California’s share of this licensing income is likely to be less than one percent of R&D expenditures in current dollars. The allocation of these relatively small revenues is of secondary importance to the greater objective of disseminating CIRM-funded stem cell technology quickly and widely. While investments in stem cell research will generate some financial return for the state of California, the primary benefits from these investments will be progress toward improved therapies for the treatment of major chronic and acute diseases. To be more precise, if income generation were the sole justification for stem cell research funding (which of course it is not), the State would be better off investing in its own municipal bonds.

II. Royalty Income
There are several ways to estimate expected royalty income from CIRM-funded research. The Baker-Deal study uses a “prospective” approach, which estimates the likely number of major new therapies that will be introduced using technologies developed with CIRM research support and the expected revenues from these new therapies, and applies a royalty rate to estimate licensing income. An alternative approach is “retrospective”, based on actual royalty generation by research funded by universities, hospitals and research institutes. Both approaches have merit as a way to estimate likely royalty income. The time cost of revenues is a major issue, because it takes years to apply basic stem cell research to produce useful therapies and many more years for those therapies to wind their way through the U.S. Food and Drug Administration approval process, although the CIRM may be able to generate some revenue over an earlier time frame by licensing technologies used as research tools to develop new therapies. Another possible way for the CIRM to accelerate income is to negotiate equity in companies that license its technologies and to profit from equity sales that capitalize the future value of stem cell research. I discuss factors that limit the ability to generate licensing income in Section III below and alternative licensing arrangements and their limitations in Section IV.
The Baker-Deal methodology

The Baker-Deal report estimates that research funding by the CIRM is sufficient to develop, in expected terms, 3.4 major new therapies, based on historical costs adjusted for inflation in the cost of health care R&D. The report projects $3 billion in revenues from a major biotechnology therapy. In their base case the authors assume that the State will earn a royalty of two percent of sales of CIRM-funded therapies. This gives a nominal return of $60 million per major therapy and total royalty revenue of about $204 million for the estimated 3.4 therapies developed from CIRM-funded research. The authors assume a gap of ten years between the funding point and the start of royalties and inflate future royalty streams by an expected health care inflation rate of 4.2 percent to account for expected increases in the future cost of drug therapies. Inflation increases the cumulative royalties to $537 million in their base case and $1.1 billion in their high estimate, which assumes a royalty rate of four percent of sales.

The obvious problem with this calculation is that a dollar of revenue earned ten years in the future does not have the same value to the State as a dollar of revenue earned in the present. The study accounts for inflation in health care costs, but does not discount future revenue flows. In their defense, the authors report only projected revenue flows, not the value of these revenues. A correct value calculation should discount future revenue flows by the time value of money. While reasonable people may disagree over the appropriate choice of a discount rate, a number at the low end of the range is the rate of interest paid by ten-year treasury bonds. Treasury bonds are exempt from state taxes, but not federal tax. Investments by a state should count federal taxes as a cost, but not state taxes, as they are returned to the state coffers. The interest rate for treasuries, also called the yield, is consistent with these financial flows.5

5 An argument could be made for discounting future revenues using the much higher rate of return on private investment, which is the opportunity cost of using state funds. There is a large literature on the appropriate discount rate. See, e.g., Peter G. Warr and Brian D. Wright, “The Isolation Paradox and the Discount Rate for Benefit-Cost Analysis,” The Quarterly Journal of Economics, Vol. 96, No. 1 (Feb., 1981), pp. 129-145.
In June 2006 the ten-year treasury bond yielded about 5.0 percent.\(^6\) Discounting the estimated royalty flows in the Baker-Deal study by this rate reduces the value of these royalties from $537 million to about $189 million in current dollars, or about 35 percent of the royalty revenue reported in the study. The study’s high estimate assumes that the State would earn a royalty of 4 percent of sales, which corresponds to a present value royalty income of about $379 million from the State’s $3 billion research investment.

Applying the interest rate on treasury bonds reduces the estimated royalties in Baker-Deal study by about 65 percent. A higher discount rate, which is arguably appropriate to account for the high risk of stem cell R&D, would result in still lower present value royalty income. The state’s actual payout of licensing income would be less than the discounted numbers indicate, because the CIRM anticipates a policy that would assign a share of royalty income to grantee organizations and inventors, consistent with the grantee organizations’ normal policies for other externally funded R&D. This is a sensible policy. It ensures that inventors have the same financial incentives to work on CIRM-funded research projects as they do for other projects and does not unduly discourage research entities from accepting CIRM grants.\(^7\) The current CIRM intellectual property policy requires no payment of licensing revenues to the State of California unless total royalties earned by grantee organizations, net of payments to inventors, exceed a threshold of $500,000, adjusted for inflation. For royalties that exceed the threshold, the policy specifies that the grantee organization shall pay 25% of its share after payments to inventors to the State of California.\(^8\) As an example, the University of California’s current policy permits inventors to retain 35 percent of net licensing income from their discoveries.\(^9\) For royalties from inventions funded by the CIRM, 25 percent of the remainder, or about one-sixth of total revenues, would go to the


State. If other funding sources were used in the creation of a CIRM-funded patented invention, the State’s return would be proportionate to its share of research support provided by the CIRM. The CIRM sharing rule (one quarter to the State after deducting 35 percent for the inventor’s share, assuming the therapies predicted in the Baker-Deal study exceed the CIRM threshold) would reduce the State’s share of estimated royalty income to about $31 million in the Baker-Deal study base case and $62 million in the study’s high estimate.

These estimates of royalty income to the State are only a few percent of the total investment in stem cell research that will be funded by the CIRM. Under these scenarios, the State’s financial return from royalty income for research funded by the CIRM will be extremely modest. The state of California clearly will not earn a profit from royalties on stem cell technologies funded by the CIRM, nor will royalties return a significant fraction CIRM expenditures to the State.

A retrospective approach
An alternative approach to estimate likely royalty income from CIRM investments is to extrapolate into the future the royalties actually earned by universities, hospitals and research institutes on their past R&D investments. This estimate is retrospective because it is based on returns to historical R&D expenditures rather than likely future returns to expenditures by the CIRM. Most CIRM grantees will be associated with universities, hospitals and research institutes; hence licensing revenues from these organizations, particularly hospitals and health-related research institutes, provide an appropriate baseline to estimate revenues from CIRM licenses.¹⁰

As a reference point, Table 1 shows licensing income from sponsored research at universities and research institutes surveyed by the Association of University Technology Managers (AUTM) for fiscal years 2003 and 2004. For fiscal year 2003 the AUTM reported total licensing income of $866,814 and total research expenditures of

$34,826,920. The corresponding figures for fiscal year 2004 are licensing income of $924,842 and total research expenditures of $37,162,153. For both fiscal years, licensing income averaged about 2.5 percent of research expenditures.\textsuperscript{11}

Licensing income earned by U.S. hospitals and research institutes surveyed by the AUTM was a considerably larger fraction of sponsored research expenditures in FY 2003 and 2004. In fiscal year 2003 these hospitals and research institutes earned licensing income of about $292 million and had total research expenditures of about $3.7 billion. For fiscal year 2004 the corresponding figures are licensing income of $314 million and revenues of about $4.1 billion. Licensing income was 7.9% of sponsored research expenditures at hospitals and research institutes surveyed by AUTM in FY 2003 and 7.7% of sponsored research expenditures in FY 2004.

Table 1. AUTM Licensing Survey: FY 2003 and 2004

<table>
<thead>
<tr>
<th></th>
<th>All U.S. University Research</th>
<th>U.S. Hospitals and Research Institutes</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>FY 2003</td>
<td>FY 2004</td>
</tr>
<tr>
<td>Sponsored Research Expenditures ($000’s)</td>
<td>$34,826,920</td>
<td>$37,162,153</td>
</tr>
<tr>
<td>Net License Income ($000’s)</td>
<td>$866,814</td>
<td>$924,842</td>
</tr>
<tr>
<td>Net License Income as Percent of Research Expenditures</td>
<td>2.5%</td>
<td>2.5%</td>
</tr>
</tbody>
</table>

The licensing income reported in Table 1 is net of legal fees, but not of other administrative costs associated with running a technology transfer program. Data on overhead costs are available for the University of California’s technology transfer program. For fiscal years 2000 through 2004 the University of California system-wide Office of Technology Transfer incurred operating expenses other than legal and other

\textsuperscript{11} Source, AUTM Surveys, Fiscal Years 2003 and 2004.
direct expenses equal to about 15 percent of total licensing revenues.\textsuperscript{12} Deducting 15 percent for operating expenses reduces the net licensing income in Table 1 to about 2.1% of research expenditures for all university research and 6.6% of research expenditures for U.S. hospitals and research institutes.

Licensing income earned by U.S. hospitals and research institutes is arguably more representative of the potential income that will be earned by the California Institute of Regenerative Medicine. Independent survey research by Castillo, Parker and Zilberman (1999) provides further evidence that licenses for medical products and process technologies are likely to command higher royalty percentages than licenses for many other discoveries. Respondents to a survey of 36 universities reported royalties of 6.3 to 9.4 percent of sales for medical products compared to an average royalty of 3.9 percent of sales for agricultural products and 6.3 percent for engineering products.\textsuperscript{13}

The higher royalties earned on health care technologies reflect the large share of research and development expenses in the medical products sector. In 2001, R&D expenses were 7.8 percent of net sales for pharmaceuticals and medicines and at least 9.0 percent of net sales for medical equipment and supplies,\textsuperscript{14} compared to an average for all industry of 4.1 percent.\textsuperscript{15} The greater importance of R&D in these industries allows a licensor of new technology to bargain for a larger fraction of net sales relative to royalty percentages in many other industries. The value of a technology to a potential licensee is the amount that the technology saves in product development costs or the additional value that the technology allows the licensee to offer its customers. If R&D costs average only four percent of product revenues, a potential licensee in a competitive market would not be willing to pay a royalty of more than four percent to license an R&D technology unless

\textsuperscript{12} University of California Technology Transfer Program Annual Report, Fiscal Year 2005, Exhibit 26 at 16. Total licensing revenues exclude a one-time $200 million legal settlement related to its human growth hormone invention. Including this amount reduces the share of operating expenses to about ten percent of total licensing revenues.


\textsuperscript{14} National Science Foundation, Science & Engineering Indicators – 2004, Table A-20. This figure omits federal funding for R&D.

\textsuperscript{15} National Science Foundation, Science & Engineering Indicators – 2004, Table A-19.
the technology offers an increase in value that the licensee can capture with a higher price. Competition caps the royalty that the licensee can offer. A licensee could offer more in a market where it has more pricing discretion, although the licensee would not pay a royalty that exceeds its own cost of investing in R&D to develop an alternative technology or the cost of licensing an alternative technology from another source.

The numbers in Table 1 compare current royalty income to current research expenditures. However, current royalty income is the payoff for research expenditures that occurred many years in the past. Research discoveries take years to be transformed into potentially useful products, and regulatory approval adds several more years before potentially useful drugs and therapeutics can be marketed. A more accurate estimate of the payoff to R&D would compare R&D investments to expected future payoffs adjusted for the time value of money. Detailed estimates depend on a number of assumptions, including the lag between R&D investment and the launch of commercial products, assumed rates of inflation in health care costs and prices, real discount rates, and the time profile of royalty revenues and licensing expenses.

A partial correction for the temporal effects of R&D and the receipt of royalty income uses the royalty income in Table 1 (adjusted for operating expenses) as a proxy for royalties that will occur in the future as a result of the R&D expenditures shown in the table. This calls for discounting royalties by a real, inflation-adjusted discount rate to account for both increases in health care costs and the time value of money. Assuming a lag of eight years between R&D expenditures and the receipt of income and a real discount rate of five percent, the ratio of royalty income to R&D falls to about 4.5 percent.

The State’s actual licensing income will be a much smaller fraction of its R&D expenditures. Following the revenue sharing policies currently adopted by the CIRM, the State will receive about one-sixth of total royalty revenues (25% after deducting an inventor share of 35%). These policies reduce my estimate of the State’s licensing
revenues to less than one percent of CIRM-funded expenditures on stem cell R&D (one sixth of the estimate the total rate of return on research investment of 4.5 percent).

This estimated return implicitly assumes that all CIRM-funded R&D projects will exceed the CIRM threshold for paying royalties to the State. In fact, few technologies generate revenues that exceed the CIRM threshold, although those that do account for a high share of total licensing income. After deducting an inventor share of 35 percent, the CIRM threshold is a total royalty income of about $770,000. In fiscal year 2004 the University of California at San Francisco (a major hospital and healthcare research institution in the University of California System) generated net royalty income of $18.2 million from 298 active licensing agreements, an average of $61,084 per agreement. Assuming that a license produces revenues for ten years, the average license revenue would not exceed the CIRM threshold after deducting the inventor’s share. The CIRM royalty threshold would have a much smaller impact on the State’s share of revenues from the most successful inventions, which account for a very large share of licensing income. While the University of California system had almost one thousand active licenses in fiscal year 2004, the 25 licenses with the largest royalty income accounted for almost eighty percent of all royalties. All of these licenses earned cumulative royalties in excess of $770,000. Reducing my estimate of royalty income paid to the State of California by 20 percent to account for technology royalties that do not exceed the CIRM threshold lowers my estimate of the ratio of royalty income to R&D spending to about 0.60 percent in present value terms. At this rate, the State would be better off investing in its own municipal bonds.

It is not out of the realm of possibility for research expenditures to produce very high royalty returns. In 1998, Florida State University earned royalties from technology licenses that totaled $46.6 million. The entire Florida State University research budget in that year was $112 million. Royalty income at Florida State was 41.6 percent of research

---

17 Ibid., at 8, 10.
18 University of California Technology Transfer Program Annual Reports for Fiscal Years 2000-2004 confirm that total royalties exceeded the $770,000 threshold for all of the top 25 royalty-earning technologies in FY 2004.
expenditures in 1998.19 Research at Florida State University was instrumental for
synthesis of the drug Taxol, a treatment for ovarian, breast, lung, and testicular cancer. 
Approved by the FDA for initial marketing at the end of 1992,20 by 2001 Taxol had
become the best-selling cancer drug in history.21 Florida State University earned $67
million in royalty revenues in 2000, roughly 4.2 percent of product sales, nearly all of
which was royalties from its technology to synthesize Taxol.22

Royalty income from stem cell technologies would more than pay for the cost of R&D if
the CIRM could reliably turn out patents such as the Florida State University patent for
the synthesis of Taxol.23 Of course the Taxol patent is an outlier among outliers, a
celebrity patent in the world of university technology transfer. Furthermore, taking the
time value of money into account, it would require more than fifteen patents as lucrative
as Taxol for the CIRM to earn a market rate of return on its R&D expenditures solely
from licensing income.24 This is implausible given that the annual research budget of the
CIRM, about $350 million per year for ten years, is only about ten percent of 2003
expenditures on academic R&D in the health sciences in California.25

Forecasting is risky. It is possible that research funded by the CIRM will lead to a
number of technologies that have as much or more commercial success as the Cohen-

at 4.
20 U.S. General Accounting Office, Technology Transfer: NIH-Private Sector Partnership in the
21 Ibid. at 1.
22 Ibid. at 13. The U.S. GAO reported that 98 percent of the licensing income earned by Florida State
University in 2000 was from the license for its Taxol synthesis patent.
23 The National Institutes of Health provided Florida State University with a $2 million grant to subsidize
its Taxol synthesis research.
24 Suppose that a blockbuster patent (such as Florida State’s Taxol patent) generates $60 million in
royalties per year for ten years. Assuming that revenues begin eight years after R&D expenditures and
applying a ten percent discount rate gives a total present value of about $200 million. Fifteen times this
number is still less than the CIRM R&D budget.
25 Expenditures on academic R&D in California were $5.36 billion in 2003, of which 58 percent was in the
Implementation of California’s Stem Cell Research Program,” Stanford Institute for Economic Policy
Research, October 2005 and “The Politics and Economics of Implementing State-Sponsored Embryonic
at 34.
Boyer technology or other blockbuster patents such as Florida State’s patent on Taxol. However, if we have to forecast, it is safer to rely on historical average returns for a large sample of R&D investments, rather than extrapolating from Taxol or gene-splicing technologies to all CIRM-funded R&D.

There is an upside to my estimate that the State is not likely to earn a substantial return on its investment in stem cell R&D solely from royalty income generated by licenses for its discoveries. Significant royalty income could put the CIRM at risk of losing tax-exempt status for its bond funding. The loss of tax-exempt status would have an immediate adverse impact on the cost of financing R&D by the CIRM. In the Fall of 2005, then California State Treasurer Philip Angelides estimated a difference of 75 basis points in interest costs between long term taxable and tax-exempt general obligation California State bonds, and the spread would be higher in a higher interest rate environment. The 0.75 percent difference exceeds my estimate of the royalty income that the CIRM is likely to earn from its stem cell research. If the receipt of royalty income places the CIRM at risk of losing tax-exempt status, the State would be better off abandoning any claim to royalty income. This also would have the additional albeit small advantage of promoting the development and dissemination of stem cell therapies by eliminating a small royalty tax on users of CIRM-developed technologies.

---

26 Whether royalty income would negate tax exempt status is not clear. See, e.g., October 26, 2005 letter from then California State Treasurer Philip Angelides to CIRM President Zack Hall noted that “the use of state bond financing to fund stem cell research is a new frontier in federal tax law.” http://www.etopiamedia.net/empnn/pdfs/angelides-hall1.pdf, accessed June 16, 2005.

27 Ibid.

28 The Proposition 71 charter that created the CIRM specifies that the ICOC shall establish standards that allow the State of California to benefit from the patents, royalties, and licenses that result from the activities of the CIRM. See text of Proposition 71, Section 5, Chapter 3, Article 1, footnote 1, infra. The CIRM document “Intellectual Property Policies for Non-Profit Organizations” describes its current policies with respect to patents, royalties, and licenses. See footnote 8, infra. My recommendation could run afoul of this requirement, although the quantitative impact would be small in present value terms.

29 A running royalty increases the marginal cost of using the licensed technology or selling a product made with the licensed technology. The effect of this increase in marginal cost is similar to the effect of an ad valorem tax.
III. Why is Licensing Income So Low?

Historically, non-financial corporations in the U.S. have earned rates of return on their capital investments in excess of 10 percent per annum.30 This means that an investment of $100 in physical capital earns, on average, in excess of 10 dollars every year for the foreseeable future. Some estimates of average rates of return on investments in R&D are much larger.31 Yet royalties on sponsored R&D have averaged only two to eight percent of the cost of these investments and much less when adjusted to account for the long delays between R&D expenditures and the receipt of royalty income. What explains the fact that, historically, Universities and research laboratories have captured only a small fraction of revenues related to their R&D? There are many explanations, several of which I explore below.

1. The value of R&D is highly uncertain

While some research, such as that leading to Taxol or to the discovery of recombinant DNA techniques, has been extremely valuable, these are distant outliers. Most R&D discoveries generate no royalty income. The distribution of royalty income from R&D programs is highly skewed. Only four of the 32 university hospitals and research institutes surveyed by the Association of University Technology Managers earned total revenues from technology licensing that exceeded $40 million in 2004. Three-quarters of the hospitals and research institutes in the AUTM survey earned total revenues of less than $6 million from technology licensing in 2004. The median total income from technology licenses in 2004 was in the range of $2 to 3 million; that is, half of the university hospitals and research institutes in the survey earned less than $2 to 3 million in total royalty income from technology licenses in 2004.32 The fact is that most basic

research would earn little or no licensing income even if the research institution could bargain for a larger share its value.

Table 2 shows the top five sources of licensing revenues earned by the University of California system for the years 1996, 2000, and 2004. The table also shows the total licensing revenue for the University of California system in each year and the fraction of total licensing revenue earned by the license with the largest revenues. A single technology, the Hepatitis-B vaccine, accounted for more than 40 percent of University of California licensing revenues in 1996 and for more than a third of all University of California licensing revenues over these years.

Table 2. Licensing revenues earned by the University of California System ($000’s)

<table>
<thead>
<tr>
<th>FY 1996</th>
<th>FY 2000</th>
<th>FY 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Radiographic Media (1979)</td>
<td>$1,214</td>
<td>Camarosa strawberry (1992)</td>
</tr>
</tbody>
</table>

|          | Total Licensing Revenues | $63,204 | Total Licensing Revenues | $67,765 | Total Licensing Revenues | $79,265 |
| Largest as Percent of Total | 40.2% | Largest as Percent of Total | 39.0% | Largest as Percent of Total | 23.9% |

Other university licensing programs also illustrates the importance of single blockbuster discoveries. Revenues from licenses for the Cohen-Boyer patent for gene splicing accounted for roughly half of the technology licensing revenues earned by Stanford University over the life of the patent. More than half of the licensing revenues earned by Harvard University in fiscal year 2004 came from licenses for Cardiolite, a tool for

diagnosing coronary artery disease. Harvard had 554 active licenses in fiscal year 2004, only two of which generated income of more than $1 million, while 58% produced income of less than $10,000.\footnote{35} The University of California at San Francisco, a major hospital and research institution, reported that about 98% of disclosed inventions earn less than $100K per year in licensing income and about 80% earn less than $10K per year.\footnote{36}

The highly skewed distribution of licensing royalty income for university hospitals and research institutes suggests that licensees have to bear the risk that most of the technologies they license will be dry holes. The very few gushers have to compensate for expenditures by licensees that generate little or no return.\footnote{37} For this reason, licensees are unlikely to be willing to share a large fraction of the revenues from licensed technologies with the licensor. Doing so would sap the licensee of the economic returns generated by the occasional technology that has very substantial value.\footnote{38}

2. **Distant payoffs**

New drug development requires a sequence of discovery, preclinical development and testing in assays and animals, clinical testing on humans, and regulatory approval, each of which incurs delays and risk of failure. Clinical testing typically begins with small-scale tests on volunteers, then moves to larger-scale tests on targeted populations, and finally to larger scale tests that are designed to establish efficacy and identify undesirable side-


\footnote{37} In their study of the returns to pharmaceutical R&D, Grabowski and Vernon observe that if the top-selling drug were excluded from the cohort introduced between 1980 and 1984, the remaining drugs would fail to break even on average. Grabowski, Henry G. and J. Vernon, “Returns to R&D on new drug introductions in the 1980s,” Journal of Health Economics, v. 13, 1994, pp. 383-406, at 399.

\footnote{38} Cochrane observes that when the distribution of returns is highly skewed, as in a lognormal distribution, variance contributes to expected value as well as to risk. If returns have a lognormal distribution with mean $\mu$ and variance $\sigma^2$, the expected return is $\exp(\mu + 1/2\sigma^2)$, which is an increasing function of the variance. Variance is a problem for a licensee because it implies that a small set of licenses has a high probability of earning little or no return.
effects. It is only after these clinical tests are completed that a drug manufacturer submits a new drug application (NDA) or a biological license application (BLA) to the U.S. Food and Drug Administration.

Mansfield (1998) traced the lag between the publication of academic research results and the first commercial introduction of new products and processes based on those results. He surveyed a sample of innovations in several industries during the time periods 1975-1985 and 1986-1994. For “Drugs and Medical Products”, Mansfield reports lags that range from 6.2 to 10.3 years, depending on the time period of the survey and on whether the academic research was necessary or only a very substantial aid for the development of the new drug or medical product.

DiMasi, Hansen and Grabowski (2003) estimated a mean time between the start of clinical testing and submission to the FDA of a new drug application or new biologic license application equal to 72.1 months. At the time of their study the mean time required for FDA approval was 18.2 months, resulting in a total lag from the start of clinical testing to marketing approval of a new drug equal to about 7.5 years. This is within the range of estimates by Mansfield (1998), but underestimates the lag from basic

40 A biologic product is any virus, serum, toxin, antitoxin, vaccine, blood, blood component or derivative, allergenic product, or analogous product applicable to the prevention, treatment, or cure of diseases or injuries. Biologic products are a subset of "drug products" distinguished by their manufacturing processes (biological process vs. chemical process). In general, the term "drugs" includes biologic products. See http://www.fda.gov/cder/drugsatfda/glossary.htm#B, accessed May 7, 2006.
42 Ibid. at 164.
43 In recent years the FDA has reduced the average lag for new drug approvals. The approval time for a new molecular entity (NME) fell from about two years in the early 1990s to about one year in 1999, but then increased to over 15 months in 2000. A NME is medication containing an active substance that has never before been approved for marketing in any form in the United States. See http://www.fda.gov/cder/reports/reviewtimes/default.htm, accessed May 7, 2006. Approval times for NMEs could be somewhat longer than approval times for NDAs, which may be based on familiar chemical compounds. New drugs made with stem cell technologies are likely to be NMEs and hence have longer approval times than for NDAs. However, the approval time could be as low as six months if classified as a priority new drug application.
R&D to marketing approval for a new drug because considerable R&D is necessary before a drug can enter clinical testing.\(^{44}\)

With private discount rates in the range of 10-15 percent per year, the effect of delay between R&D expenditures and commercial products is a very large reduction in the financial value of that R&D. Suppose a CIRM program costs $100 million and, after a ten-year delay for product development, testing and regulatory approval, leads to a drug that earns $200 million per year for ten years, for a total of $2 billion. The nominal payoff from the CRIM R&D is impressive. The R&D program earns $20 in revenue from each dollar of R&D. But accounting for the time value of money with a 15% discount rate makes the R&D investment much less attractive. First, the present value of the revenues from the drug falls by almost half from $2 billion to about $1.15 billion. Second, the ten-year delay between R&D and the commercial product further reduces the ultimate payoff from $1.15 billion to about $285 million. The R&D program still turns a tidy profit, but now the payoff falls from $20 in nominal revenue for each dollar of R&D expenditure to less than $3 in present value revenue for each dollar of R&D expenditure.

The time value of money takes a devastating toll on the payoff from basic research and development. The risk that any products that might emerge from basic R&D may fail to win regulatory approval or encounter market obstacles further reduces the benefits from R&D.

The lags between R&D on stem cell technologies and revenues from products that use these technologies are likely to be on the high side of these estimates. Any new therapeutic products based on research in regenerative medicine will require extensive testing and will face regulatory hurdles and likely legal challenges that will impose long delays to commercial product introduction. Research and development tools developed at the CIRM may earn royalty streams with a shorter delay. However the value of these tools will be limited by the long delays between the use of the tools and the generation of

revenues from approved products that are designed, developed or produced using these tools.

3. **Need for large additional investments**

The majority of technologies licensed by universities are at an early stage of development and there is no reason to believe that technologies developed by the CIRM will be any different.\(^{45}\) The commercialization of a new therapeutic treatment typically requires expenditures of many millions of dollars in development, testing, and approvals, and millions more to market the new treatment. A prospective drug manufacturer first must submit an investigational new drug application (IND), which demonstrates results of pre-clinical testing in laboratory animals. Based on the IND, the FDA decides whether it is reasonably safe to move forward with testing the drug on humans. Clinical trials on humans proceed in three stages. Phase 1 studies are small-scale treatments usually conducted on healthy volunteers. If results from Phase 1 studies are acceptable, Phase 2 trials begin with subjects ranging from a few dozen to about 300. Phase 3 studies begin if evidence of effectiveness is shown in Phase 2 without unacceptable side effects. These studies gather more information about safety and effectiveness, studying different populations and different dosages and using the drug in combination with other drugs. The number of subjects usually ranges from several hundred to about 3,000 people.\(^{46}\) It is only after these clinical tests are completed that a drug manufacturer submits a new drug application or a biological license application to the U.S. Food and Drug Administration. On average, drug development costs increase dramatically in each clinical phase prior to FDA approval.\(^{47}\) DiMasi et al. estimate that the average cost of developing a drug to the point of marketing approval was $802 million for a sample of 68 drugs first tested in humans between 1983 and 1994.\(^{48}\)

---

\(^{45}\) In a survey of technology transfer offices of 62 major universities, Thursby et al. found that a majority of the technologies licensed by these offices were at an early stage of development and about half were only a proof of concept when they were licensed. Jerry G. Thursby, Richard Jensen and Marie C. Thursby, “Objectives, Characteristics and Outcomes of University Licensing: A Survey of Major U.S. Universities,” Journal of Technology Transfer, vol. 26, 2001, pp. 59-72 at 59, 62.


\(^{47}\) DiMasi, Hansen and Grabowski (2003) at 171.

\(^{48}\) *Ibid.* at 151.
Given the nascent state of most technologies developed in universities and other basic research institutes, the large investments necessary to transfer these technologies into useful products and the high risks of failure, it is not surprising that licensees are unwilling to commit to large upfront payments or to share a high percentage of the value of successful products with their licensors.

4. Bargaining power
Another possible reason for small royalty shares is that technology transfer managers have little bargaining power or simply are not effective bargainers. Bargaining power is a function of a party’s threat point: the value the party can earn by walking away from an agreement. For technology managers this threat point may be quite low in many circumstances. Thursby et al. note that while multiple potential licensees often examine a technology, it is much less frequent for multiple companies to become involved in license negotiations. A technology manager’s threat is to license the technology to another company, but that threat is absent if there is only one serious potential licensee. The licensee’s threat is to license a substitute technology from another source or develop the technology in-house, both of which may be viable alternatives. For many technologies the licensee will have the upper hand in the licensing negotiations.

IV. Licensing strategies to increase returns
Licenses come in different forms. A license can specify a fixed fee, a running royalty, or a share of equity in the assets of the licensee, or require payments that are conditional on meeting certain thresholds such as use of the licensed technology in commercial production of goods or services. In a paid-up or pure fixed fee license the licensee makes a one-time payment for the right to use or sell the licensed technology. Running royalties are payments that vary with sales of products made using the licensed technology, usually calculated as a percentage of gross sales or a per unit fee. These license terms are not

49 Thursby, Jensen and Thursby, *op. cit.*, at 63.
mutually exclusive. Licenses can combine fixed fees and running royalties and in addition may include some equity ownership.

Figure 1 shows the distribution of revenues earned by all university technology licenses over the period fiscal year 1996 through fiscal year 2004. Running royalties account for by far the largest share of university licensing revenues, averaging 77 percent of license income over this period. The other two categories in Figure 1 are cashed-in equity, which is the amount collected from sales of equity holdings in technology licenses, and “other”, which includes fixed fees as well as other sources of license income such as litigation settlements.

Running royalties are close to 80 percent of the total in every year from FY 1996-2004 except for FY 2000, and this holds at a more disaggregated level for hospitals and research institutes as well as for total university licensing reported by the Association of University Technology Managers. FY 2000 was unusual because the University of California recorded a $200 million settlement of an infringement suit involving its human growth hormone patent, which is included in the “other” category for that year.50 Leaving out FY 2000, the “other” category (which includes fixed fees) accounted for only about 16 percent of university licensing revenues over the period 1996-2004.

---

This result may appear odd, at least to economists. Under some conditions, an exclusive license with a fixed fee and no running royalty is a good way for a licensor to recover the value of licensed intellectual property. With no running royalty, or a running royalty equal to the marginal cost of transferring the technology, a single licensee can earn a monopoly profit as the sole supplier of the licensed technology, which the licensor can extract with a fixed fee. A running royalty that exceeds the marginal cost of transferring the technology imposes an artificial cost on the licensee and reduces the total available profit for the licensor. Thus, in theory and with a number of implicit assumptions, a license with a fully paid-up royalty and with little or no running royalty would extract the maximum profit from a licensed technology.

---

This argument has not had much traction for managers of university technology transfer offices. Fixed fees represent a small share of licensing revenues, with the lion’s share from running royalties. Furthermore, less than half of university licenses are exclusive and the share of licenses that are exclusive has fallen over the past several years (Figure 2).

![Figure 2. Share of university technology licenses that are exclusive](image)

Are university technology managers missing an opportunity to earn more from licenses, or is the simple economics story too simple, and what lessons can we learn from university technology managers for licensing by the California Institute for Regenerative Medicine? The argument that an exclusive license with a fixed fee and with little or no running royalty is a good way for a licensor to recover the value of licensed intellectual property is indeed too simple. It omits many considerations in real-world licensing that affect the potential for licensing income. I list a few of these considerations here.

---

**Uncertainty**

A fixed fee burdens the licensee with the risk associated with the new technology. As demonstrated above, most technology licenses generate little or no income, not because the royalty rate is low, but because most technologies do not realize significant commercial value. Reflecting this risk, the demand for licenses from potential licensees is often quite low. In a survey of university licenses granted from 1991-1995, only 22 percent had greater than one bidder.\(^{53}\) The uncomfortable fact is that most exclusive university licenses are exclusive because only one potential licensee was willing to pay for the right to use the technology, not because the university technology transfer manager limited the license to a single licensee.

University technology managers typically are not flush with bids for exclusive licenses. The University of California at San Francisco Office of Technology Management notes that not all patented life science technology is licensable (i.e. affords value to a commercial developer), because the technology requires more research and development to attract commercial interest, the market for the technology is inadequate, the patent claims are too narrow or difficult to enforce, the technology is not sufficiently differentiated from other technologies, or products made using the technology cannot be manufactured economically.\(^{54}\)

An exclusive license also creates uncertainty for the licensor. The licensor faces the risk that the chosen licensee is not the best entity to develop the commercial potential of the licensed technology. The licensor could protect against underperformance by the licensee by including minimum payments, contingent payments and termination provisions, however these terms are typically difficult to negotiate. Furthermore, even a licensee that performs well may choose not to develop the commercial potential of the licensed technology in every application.\(^{55}\)

---


\(^{55}\) Gregory Graff et al. offer the example of an exclusive license to Monsanto for genetic engineering of plants, which Monsanto chose not to exploit for some minor crops. See Gregory Graff, Amir Heiman and
Moral hazard

Moral hazard exists when the structure of a license fails to offer incentives for efficient investment in the licensed technology. A common theme expressed both by university technology transfer managers and by those who have studied technology transfer is that new technologies licensed by universities and research institutes typically require a great deal more research and development to become commercially useful.\textsuperscript{56} Often the inventor of the technology has the intellectual ability and sometimes the entrepreneurial capacity to contribute to this additional research and development. A paid-up license, however, offers no pecuniary incentive for the inventor to invest in the technology after the license has been negotiated, because the inventor’s compensation does not depend on its commercial performance. With a running royalty the inventor’s compensation depends on the commercial performance of the technology, which motivates the inventor to participate in its development after negotiation of the license.\textsuperscript{57} Alternatively, an equity share also offers the inventor an incentive to increase the value of the equity by participating in the development of the licensed intellectual property.\textsuperscript{58}

A single licensee can’t do it all

An exclusive fixed fee license presumes that the exclusive licensee can satisfy all of the demand for products made with the licensed technology in a cost-efficient manner. The exclusive licensee cannot efficiently supply all of the demand for products if the licensee incurs diminishing returns to scale or faces other constraints that limit its ability to exploit the full potential of the licensed technology, including limits on its ability to explore creative applications for the new technology. The technology licensor could permit the licensee to sublicense others, and extract some of the value of the sublicenses with the fixed fee. However, this requires that the licensee identify the appropriate sub-licensees


\textsuperscript{57} See Jensen and Thursby, footnote 53, \textit{infra.}, at 248. (development requires a positive royalty rate when the contract terms specify a royalty and/or fixed fee).

\textsuperscript{58} There may be a dilution effect that reduces inventor incentives if the value of equity depends on activities that are unrelated to the licensed technology. See Jensen and Thursby, \textit{ibid.}, at 251 (footnote 26).
and that the licensor, the original licensee and the sub-licensees negotiate terms for sharing profits. This is a complex undertaking with the potential to sacrifice potential economic surplus. Furthermore, there is little assurance that the licensor would be able to capture a high share of the remaining surplus, particularly with limited competition among potential licensees for the rights to an exclusive license.

An alternative is to license the technology non-exclusively to all takers with a running royalty and low or no upfront fees. This strategy limits the profit that the licensor can extract from each licensee, but royalties from a large number of licensees can more than compensate for a high fixed fee from an exclusive licensee. The licensing history of the Cohen-Boyer patent for recombinant DNA is a case study on point. Patented in 1980, the Cohen-Boyer technology for inserting genes in cells was the foundation for the biotechnology revolution. The decision was made to license the patent non-exclusively, in part out of concern that one company could not explore all of the possible applications of the technology and in part because potential licensees feared that they would be excluded if the patent were licensed to a single company.59 A total of 468 companies ultimately licensed the Cohen-Boyer technology and paid a total of $254 million during the patent’s term, 90% of which was from running royalties.60 It is unlikely that adoption of the Cohen-Boyer technology would have been as pervasive with an exclusive license and it is also unlikely that an exclusive license would have generated as much revenue for its licensors.

Not all licensees are alike

Suppose that efficient exploitation of a technology requires more than one licensee. If the licensor knew exactly what each potential licensee could earn from using the licensed technology, it is possible that the licensor could design a unique contract for each licensee that would extract a large share of each licensee’s profit and limit competition among licensees. However, the informational requirements of such a contract would be

60 Ibid. at 20, 23.
enormous, particularly for new technologies whose potential profitable applications are largely unknown. An alternative approach is to design a one-size-fits-all contract that most potential licensees would accept. A well-designed standard contract can increase the ability of the licensor to profit from the technology.

The optimal standard license would not be a single fixed fee, because a single fixed fee would not extract all of the available profit from each licensee. If the licensor wants to set a single fixed fee and license all firms that can efficiently produce goods or services using the licensed technology, the fixed fee would have to be the smallest fee that any licensee would be willing to pay. This would fail to extract all of the profits available from licensees that could earn more using the licensed technology. A standard license that extracts more of the available profit combines a fixed fee with a running royalty. The fixed fee can be set low enough to make the license attractive to licensees with modest profit expectations, while the running royalty can collect revenues from licensees that have large business opportunities.\(^{61}\) Indeed, a mix of fixed fees and running royalties is a common feature of most technology licenses, although running royalties account for most of the revenues.\(^{62}\)

**Equity Participation**

Licenses that include an equity stake in the licensee account for only a few percent of all licenses negotiated by universities, hospitals and research institutes surveyed by the Association of University Technology Managers over the past several years (Figure 1). This is surprising given that many potential licensees are short on cash and the option value of cashing in an equity stake is a tempting alternative to the expectation of meager royalties. Equity sharing can be an attractive way to realize the value of new technology when it is appropriate to grant an exclusive license to a firm whose business model is focused on the new technology, as in a new start-up venture. A start-up with a focus on


the new technology avoids a dilution of effort and interest that could happen if the
licensee is a large diversified company.63

There is, however, no reason why the *expected* value of an equity share should exceed the
*expected* present value of a royalty stream unless the equity contract itself promotes
investments that increase the value of the licensed technology. If the licensor and the
licensee agree that a license would generate $1 million in royalties, the licensee should
not be willing to give up more than $1 million in expected equity value and the licensor
should not be willing to accept less than that amount. Whether the payment to the
licensor is based on revenues produced by the licensed technology or the equity value of
the licensee is irrelevant in this example.64

There are examples of spectacular equity rewards such as Stanford University’s $336
million sale of its equity share in Google,65 which may not have been equaled with a
royalty-based license.66 There are, however, also examples of licenses that have
produced spectacular royalties, such as the $254 million in royalty income from the
Cohen-Boyer technology, and it is not obvious that a negotiated share of equity in a
Cohen-Boyer licensee would have generated an equally large return.

Equity participation is an appealing technology transfer alternative when it increases the
*total value* of the licensed technology by better aligning the incentives of the licensor and
the licensee. If an inventor has an equity share in the licensee, the inventor may have

---

63 Equity sharing, which often goes hand-in-hand with exclusive licensing, could conflict with the CIRM
goal to negotiate non-exclusive licenses to CIRM-funded intellectual property whenever possible. See
CIRM, Intellectual Property Policies for Non-Profit Organizations, footnote 8, infra, at 17.
64 Equity participation can be a last resort to obtain value from a cashed-starved licensee. Bray and Lee
report that “When [a university executive] asked one licensing manager why he had taken equity so many
times he shrugged and said it was all he could get.” Bray, Michael J. and James N. Lee, University
15, pp. 385-392, at 388. See also AUTM Annual Report FY 2004 at 30. (Equity is often the only currency
that startup companies have to offer licensor institutions as upfront consideration).
65 San Francisco Chronicle, “Google stock turns into windfall for Stanford University,” Thursday,
December 1, 2005.
66 It is conceivable that Stanford would have earned even more if it had negotiated a royalty license with
Relations at [http://investor.google.com/fin_data.html](http://investor.google.com/fin_data.html). Had Stanford negotiated a license with a royalty
equal to two percent of Google’s sales, it would have earned $64 million in 2004 and $122 million in 2005.
Stanford’s equity payout corresponds to only a few years worth of royalties at these levels.
greater motivation to work with the licensee to develop the commercial potential of the technology. A license with running royalties also offers an incentive for the inventor to work with the licensee to produce greater revenues, but equity participation can be more effective by expanding the scope of activities that can generate rewards beyond the boundaries of the licensed product or process. Licensed technologies can benefit from continued inputs of knowledge and creativity from the original inventors as well as feedback from the licensees to the inventors. An equity stake can provide a platform for these critical communications that is superior to the incentives that flow from a product or license.67

Equity sharing can create value relative to a royalty license in other ways. Equity offers some diversification benefit by assigning the licensor a share of the value of an entity rather than a share of revenues from a product or process. Equity may simplify negotiations in the event of contingencies that were not anticipated in a royalty license. For example, a licensee could have a technology opportunity that competes with the licensed technology. The allocation of effort between the licensed technology and the alternative would be a concern to a licensor with a royalty contract, though less of a concern to a licensor with an equity share in the company because equity could increase with development of either technology.68 Equity sharing can mitigate other potentially costly conflicts that might arise, such as over rights to new technologies that are developed using the licensed technology. An equity license also has the potential to realize value from the licensed technology before the technology generates significant revenue flows through the sale of equity in an initial public offering or acquisition.69

---

67 Interviews with university technology managers suggest that equity participation changes the university from being a potentially adversary of the licensee to a concerned partner. Bray and Lee at 389. See also Feldman, Maryann, Irwin Feller, Janet Bercovitz and Richard Burton, “Equity and the technology transfer strategies of American research universities,” Management Science, vol 48, no. 1, January 2002, pp. 105-121, at 106.

68 Feldman et al. note the example of an equity share for an artificial heart technology where the licensee was working on a competing technology. Equity minimized the conflicts that could have been serious with a royalty contract. Feldman at 112.

69 Bray and Lee at 389.
The pecuniary incentive in a product or process license for post-license cooperation comes from the prospect of increase royalties, which means that the contract has to be back-loaded to emphasize running royalties rather than up-front fees. But a running royalty increases a licensee’s marginal production cost, which can interfere with the dissemination of the technology and reduce its ultimate value. This risk is particularly severe when production requires many licenses, each with a running royalty, and the total stack of royalties adds to the licensee’s marginal cost. An equity participation license does not add to the licensee’s marginal cost and can avoid the distortion imposed by a running royalty.

Despite some attractive features, there are negatives to equity participation. Many technologies are not likely candidates for an equity license. If a technology offers only an incremental value to an on-going concern, a royalty license is a better way to measure its incremental contribution. Equity participation is attractive to a startup if the licensed technology has a clear commercial potential and the licensee can build a firm around it. Larger companies offer greater diversification benefits as licensees for sponsors of new technologies, but also dilute the incentives for the licensor to develop the technology because the efforts make only a small contribution to the total value of a large company.

In many respects equity sharing is the ultimate exclusive license. The choice of equity as the path to commercialize a technology discourages broad dissemination of the technology to other licensees, which are potential sources of competition that can reduce the value of the equity stake. The licensor with an equity stake in a single company may be reluctant to explore other partners to commercialize the licensed technologies, and the licensee may be equally reluctant to consider sub-licensing the technology to others. Equity participation can make it difficult to terminate an under-performing licensee, because it would require admission that the equity stake is worthless.

---

71 Bray and Lee at 388.
An equity license, with its focus on a single licensee, may contradict the objective of broad dissemination of technologies developed by the CIRM and interfere with the potential health benefits from stem cell technologies, which should be the primary objective of the CIRM. Exclusivity is not necessarily bad, because it can encourage investment to commercialize the technology; however, the CIRM has to ensure that the benefits of exclusivity do not come at the expense of broader dissemination.72

Equity licenses pose other challenges for the CIRM. Equity magnifies the risk inherent in technology transfer, with the prospect of very large rewards offset by the much larger probability of no return. With equity sharing the licensor is acting much as a venture capitalist. Successful venture capitalists are highly skilled at identifying the potential winners. If the CIRM intends to make equity sharing a major component of its licensing program, it should develop venture capital expertise in-house or acquire it from others. In the latter case, a significant fraction of the reward for picking attractive equity sharing opportunities will go to those with the expertise to choose them. Furthermore, equity participation can expose the licensor to liability for product defects, or more generally sully the licensor’s reputation as a research institution serving the public good if products sold by the equity partner harm patients or the environment. Equity can become a trap for the licensor if the need for additional investments to commercialize the technology lures the licensor into making expenditures that generate little or no financial returns.

Actual financial returns to equity licensing by universities, hospitals and research institutes have been mixed compared to royalty licenses. Bray and Lee report that the average value of equity sold in 16 university spin-off companies in 1996 was $1,384,242, while the average annual income of a royalty license was only $63,832 in 1996. These numbers, however, are not directly comparable. The equity number includes only successful equity licenses. If half the equity deals fail, this reduces the average realized value to $692,121. Excluding a few of the highest equity sales drops the average value of

72 See the CIRM concerns about exclusive licenses, footnote 63, infra.
equity sold to only $279,443.\textsuperscript{73} Equity is the capitalized value of the contract, while royalties represent income in one year. If a license generates $60,000 in royalty income for ten years and the discount rate is ten percent, the capitalized value of the royalty income is over $400,000. Furthermore, the comparison is potentially misleading because many licenses that generate royalty income would not have been suitable candidates for an equity share.\textsuperscript{74}

The evidence is that equity is not becoming a preferred method to realize technology value for universities, hospitals and research institutes. Although the number of licenses reported by the Association of University Technology Managers that include an equity share has more than doubled since 1996,\textsuperscript{75} the share of licenses with equity and startups with equity has not increased dramatically from 1996 to 2004 (Figure 3). Furthermore, with the exception of fiscal years 2000 and 2001, which offered unusually favorable conditions to realize equity values, the share of licensing income from cashed-in equity has been in the low single digits and has been falling since 1996 (Figure 4), although it is likely that FY 2005 will be a notable exception to this trend with Stanford’s sale of Google stock.\textsuperscript{76}

Equity sharing is a potentially rewarding path to commercialize CIRM technologies and it should play a role in its overall technology transfer program. However, other than Stanford’s sale of Google stock, there is not much evidence that equity sharing will significantly change historical patterns of licensing income from research by universities, hospitals and research institutes.

\textsuperscript{73} Other studies have shown that estimated equity returns from new ventures are very sensitive to adjustments for failures. In one study, eliminating failed projects reduced the average rate of return for venture capital from about 700% to 59%. The high average that remains after adjusting for failures reflects the small probability of earning an extremely large return, combined with the much larger probability of a more modest return. See John H. Cochrane, “The Risk and Reward of Venture Capital,” Journal of Financial Economics, vol. 75, 2005, pp. 3-52, at 5 and 30. See also Peng Chen, Gary Baierl, and Paul Kaplan, “Venture Capital and Its Role in Strategic Asset Allocation,” Journal of Portfolio Management, vol. 28, winter 2002, pp. 83-90

\textsuperscript{74} University policies typically limit their maximum equity share to about ten percent. See Jensen and Thursby, footnote 53 infra., at 250.

\textsuperscript{75} AUTM Annual Report, FY 2004 at 29.

\textsuperscript{76} The share of licensing income from cashed-in equity should increase dramatically in FY 2005 after recording Stanford’s $336 million share of Google stock. This figure dwarfs total cashed-in equity sales of $29 million in FY 2004. AUTM Annual Report FY 2004 at 26.
Figure 3. Share of licenses with equity

Figure 4. Share of licensing revenue from cashed in equity
V. Conclusions

The approach that the CIRM will pursue to collect revenues from the licensing of intellectual property created with CIRM R&D support is yet another source of controversy in the brief history of this institute.77 A main conclusion of this paper is that this particular controversy is a tempest in a teapot. The present value of licensing revenues is unlikely to be a source of income that will substantially offset the cost of R&D by the CIRM, taking into account the likely long lag between R&D funding and the realization of commercial therapies made possible with CIRM support. This conclusion applies only to licensing income and does not diminish the prospect that research funded by the CIRM will lead to important health benefits.78

I take two different paths to reach my conclusion about likely royalty income from CIRM-supported R&D. One approach follows the analysis performed in the Baker-Deal study, which forecasts the likely number of major therapies that CIRM support will produce and the revenues from these therapies. The Baker-Deal study estimates that the State will earn royalties from research funded by the CIRM that will total either $537 million or $1.1 billion, depending on the royalty rate. The study, however, does not account for the time cost of revenues that occur far in the future. Applying a discount rate corresponding to the interest rate on ten-year treasury bonds reduces the present value of revenues from CIRM-funded R&D predicted in Baker-Deal study by 65 percent. Under the current CIRM policy for revenue sharing, the State will receive only about one-sixth of these revenues (25% of licensing revenues after deducting 35% for the inventor’s share). This leaves the State with about $31 million in the base case of the Baker-Deal study and $62 million in their high estimate, very small fractions of the more than $3 billion in R&D funding for the CIRM.

78 Another possible benefit, which I do not address in this paper, is increased economic activity in the State of California from the activities of the CIRM. While these benefits may be important, they are unlikely to be large given that R&D funding by the CIRM is a small fraction of total academic R&D expenditures in California. See footnote 25, infra.
A second approach I use to estimate likely future royalty income from CIRM-supported R&D relies on actual royalty income collected by U.S. universities, hospitals and non-profit research institutes surveyed by the Association of University Technology Managers. The CIRM will not perform research itself, but will contract with entities, most of which will be universities, hospitals and non-profit research institutes engaged in biomedical research. For this reason the licensing revenue performance of the organizations surveyed by the AUTM, particularly hospitals and non-profit research institutes, is a good model to estimate the likely revenues from licenses for technology generated with R&D support from the CIRM.

Over the past several years, the hospitals and research institutes surveyed by the AUTM earned licensing revenues equal to about 6.6 percent of their current R&D expenditures net of operating expenses. After correcting for the lag between R&D expenditures and the receipt of royalty income and applying a time cost to future income, I estimate a return on R&D for these entities in current dollars equal to about 4.5 percent of R&D expenditures. Adjusting this number to account for the CIRM’s revenue sharing policies reduces the State’s return in current dollars to about 0.60 percent of R&D expenditures.

Although I estimate that the State of California will earn little in technology licensing royalties from CIRM-funded research, I do not regard this conclusion as particularly bad news for the State. My analysis does not undermine the value of the potentially enormous health benefits from therapies made possible by advances in human embryonic stem cell science. This is the true measure of value from the State’s support of the CIRM. Furthermore, the low expected royalty income to the State reduces the risk that royalty income will jeopardize tax-exempt status for the bonds that pay for the CIRM. Tax-exempt status reduces the cost of CIRM funding by more than the State is likely to earn in royalty income. There is little to gain, and much to lose, from struggles over policies to distribute royalty income for CIRM-funded research. There is a potential conflict between the goal of advancing stem cell science and achieving an attractive financial rate of return on California’s investment. Bad policies could undermine the CIRM’s research program by distorting incentives for inventors to work on CIRM-
funded projects. The controversy over the allocation of royalties from CIRM-funded research is a distraction from the main benefits from CIRM R&D support, which are the therapies that research funded by the CIRM will help to create.

I have also considered ways by which the CIRM may increase its licensing income. Central among these alternatives is a greater reliance on equity sharing. Taking equity in licensees of CIRM-supported technologies has a number of attractive features, but is unlikely to produce a major increase in expected licensing revenues compared to licenses that specify running royalties and up-front fees. Stanford University’s $336 million sale of Google stock is indeed impressive, but a running royalty could have produced as much income from Google’s large and growing revenue base. Equity sharing has the potential for large rewards, however the risks are great and the CIRM or its grantees would have to gain expertise as venture capitalist, or purchase this expertise, if the CIRM is to rely heavily on equity sharing to realize monetary benefits from technology transfer.

While CIRM investments in human embryonic stem cell research will generate some financial return for the state of California, the primary benefits from these investments will be progress toward improved therapies for the treatment of major chronic and acute diseases. The justification for the state’s investment in the CIRM is the promise of better health, not the promise of financial reward.