



*Arthur R. Cahill, luncheon speaker*

### CRITIQUE FROM THE VIEWPOINT OF A FINANCIAL MANAGER

*by*  
*Arthur R. Cahill\**

The dictionary defines "critique" as an article or essay criticizing a literary or other work, a review. I expect it best to tell you at the outset — since you will recognize the fact very shortly — that my comments, written or extemporaneous, will not constitute an essay, nor will they be a criticism of literary works, since (with apologies) I suspect that little you have heard or will hear today could be construed as literary works.

The dictionary also defines the word "critic" as a person *skilled* in judging the qualities or merits of some class of things.

The word "criticize" is defined as the making of judgments as to merits and faults, or to discuss merits and faults. This latter definition may be the more appropriate here today.

However, with respect to my participation, you will recall that a critic is a person "skilled in judging the qualities or merits of some class of things." So, on that basis, my participation "as a person skilled in judging" is unwarranted. However, with your patience and forbearance, I will give you my observations as related to the subject, some comments and conclusions based on financially oriented business experience, and supplemented by outside reading. Possibly my position will be that of the Devil's Advocate.

Among my reading — and I approached the subject somewhat gingerly — I have run across some interesting comments on products, processes and applications attitudes in which you might also be interested. These first commentaries were excerpted from my long-time friend, Jim Owens' recent book, "Hill Billy Humor."

Jim says that a hillbilly friend of his was complaining about everything being synthetic. "Jim", he said, "Did you know that nowadays cotton candy is thirty percent dacron?" Another of his interesting ob-

servations on products was one made by a hill woman from the section I personally came from, who complained about her new electric refrigerator using too much juice. The serviceman checked and checked, and couldn't figure out why it was using so much electricity, and then asked if she liked the refrigerator otherwise. "Yes", she said, "It's just fine. On hot days, I open the door and it cools the whole kitchen."

Jim Owens also said that he asked one of his hillbilly neighbors if he had any trouble with insects getting into his corn. "Yep", said his neighbor, "I sure do, Jim, but I just skim them off and drink it."

Another neighbor of Jim's had an elderly mother in a nursing home, and every time he visited her he took along a container of milk laced with a little brandy. She always drank the milk, but never mentioned its taste — but one day she said, "Son, will you do me a favor? Please don't ever sell that cow!"

In this same thoughtful Owens treatise, I ran across a rather typical attitude of many people today. Jim was talking to one of his good, quite old, hillbilly fishing guides. Jim said to him, "Uncle Joe, you've lived a good many years and have seen a lot of changes take place, haven't you?" "Yep", the old gentleman replied, "And I've been agin every dang one of 'em!"

I suspect that the attitude expressed by the old fishing guide highlights in some instances the first and perhaps the most important hurdle related to engineering, research, development and introduction of new products, process inventions, engineering advances, and so on. Some individuals instinctively are against change. Therefore, as Jim Eckhouse indicated so well in his presentation this morning, a successful and profitable licensing program cannot be established without the dedication of top management, a single-mindedness of purpose of the research staff, technical competence, and superiority of people and facilities. These attributes obviously must be on-going to achieve long-term success.

May I turn to some observations on what ought to be management considerations with respect to the topics covered by Jim Eckhouse, Harlan Hashbarger, Rudy Fahr, and Bob Beart. If we assume that the legal, antitrust, tax matters and form of agreement will be competently resolved, then individual managements have at least three general licensing avenues or alternatives open to them.

#### *FIRST*

The use of an existing research and engineering development and licensing operations (or the creation of an operation) as a separately profitable business entity, or as a profit division of an operating company, where the primary activity would be to specialize in licensing to others the fruits of its research, engineering and development program.

#### *SECOND ALTERNATIVE:*

The more prevalent (and perhaps most troublesome or risky) course, in which a manufacturing company licenses to others the use of its patented products, processes, and engineering techniques.

*AND THE THIRD*

The reverse opportunity for a company to become a licensee, to make use of appropriate processes and patents developed and owned by others.

The "first" and "third" alternatives were thoroughly reviewed this morning by Jim Eckhouse and Harlan Hashbarger. Therefore, the remainder of my comments largely will be directed toward the second of these three alternatives; that is, to be or not to be a manufacturing licensor. This area of management consideration may be of more importance to a larger number of companies, and deserves careful economic appraisal from both management and the licensing executive.

Let us review the advantages and disadvantages which should govern the decision of licensing or not licensing. Obviously, the arguments for and against will differ between industries, companies and objectives.

First, of course, is the company qualified to manufacture and market its new product or otherwise make use of it. If not, should the company: license a domestic company versus a foreign-based company; license a subsidiary versus an independent company; or license a newly developed patent versus a mature one. The selection of these alternatives are necessarily tied to management objectives, company resources, legal and tax considerations, etc.

In view of the time limitation to discuss in detail the complex series of judgments, I merely am going to summarize briefly a number of pros and cons. These were adapted from a Business International bulletin and accordingly are oriented toward foreign licensing agreements, but also have appropriate domestic application.

*ADVANTAGES IN LICENSING:*

1. Higher return per invested asset — R.O.I. Financial.
2. Often the fastest way to get into a market.
3. May be less danger of nationalization abroad.
4. A riskless entry with a sound company, if coupled with option to buy.
5. Minimization of currency exchange difficulties.
6. May be cross-licensing benefits.
7. Reduction of staffing problems.
8. Access to a captured market, if right company is licensed.
9. Entry to market may be too small for joint venture investment or wholly owned business.
10. Licensee's experience, sales organization, relations with local government and markets.
11. Capital equipment can be, or may be, leased to licensee.
12. Useful in industries controlled by local government (radio, TV, military, transportation entities, oil, public utilities).
13. May provide, with some risk, entry into non-capitalist country markets.
14. Control of market by licensing a manufacturer, but setting up own sales, service company.
15. Avoids joint venture arguments over financial policy, capital investment, expansion, dividends, accounting procedures, partner's tax practices.
16. No IRS trouble re intercorporate pricing.
17. No anti-trust trouble.

18. No problems with public stock issues.

Undoubtedly there are other advantages, but these are the major ones.

*DISADVANTAGES IN LICENSING:*

1. Sets up potential competitor — very important.
2. Renewals become more difficult, especially if no continuous flow of know-how is being developed, and licensee has made improvements beyond those provided or developed by the licensor.
3. Foreign government may be unwilling to accept U.S. components for critical products.
4. Foreign government may disapprove "oath of secrecy" by licensee re know-how.
5. Quality control, management, and production techniques difficult, especially for new product and improving.
6. Difficulty with licensee's sales and servicing.
7. Licensee gets spare parts business, also may switch component business to foreign or other competitors.
8. Licensee may seek third market concessions.
9. Some licensees sell inferior goods in third market under licensor's trademark.
10. Difficult liaison between manufacturing licensee and sales subsidiaries.
11. Difficult to persuade licensee to install new equipment for expanding market, lower cost, quality.
12. Licensee may refuse to pay for equipment already written off in U.S.
13. May be inflexibility; licensee cannot be coordinated for world-wide profit peaking, resources, staff, management aggressiveness.
14. Tax considerations.

As I indicated a few minutes ago, not each advantage or each disadvantage will be applicable in all instances. In addition to those already mentioned, which assume licensing, serious consideration should be given to the fundamental question of whether a company should issue a license to another company, or whether it should manufacture and modify its own process or engineering. It may be more profitable, long-range — R.O.I. — to make use of a patent, rather than license it to others. Let me repeat and re-emphasize that my remarks are primarily directed at the manufacturing company that is considering the pros and cons of making, or licensing another company, a potential competitor, to make.

I referred earlier to some outside reading, and I would like to quote from statements appearing in a paper written by Robert Stobaugh of Harvard University, Graduate School of Business Administration. He said, "Early in a product's life, we have several choices for serving a foreign market:

1. "Export from home country plant."
2. "Build a plant abroad." (Might be wholly owned or a joint venture).
3. "License a foreign company or government."
4. "In the past, most companies preferred to export from home country plant until competition forced them to build."

He goes on to say, "For a new product, aggressively investigate those countries in which you wish to maintain a subsidiary, and make an investment early while you still have a strong product position in the United

States. This action should prolong the time before a local company becomes a competitor by developing its own technology and builds a plant. Serve the other markets of the world with exports, some of which should come from your foreign plants, some from your home country."

"For mature products", he says, "With the realization that good foreign investment opportunities are going to be relatively few, you should limit your licensing to a few companies before it is done by your technology competitors."

He continues, "A smaller company with less overall balance and less ability to take the risk of wholly owned foreign subsidiaries should adopt a somewhat similar strategy. It will have to seek joint ventures, rather than wholly owned subsidiaries. It should take such ventures instead of licensing."

This completes, for the moment, the quotations from Mr. Stobaugh's paper.

Since we now have expanded our subject beyond licensing to include considerations involving a decision as to whether to license or not, I would like to cite a few economic judgments that must be made.

First, there are instances for the licensor where the payments he receives will be so substantially less than the profit he could have made, had he operated his own company or subsidiary, that licensing would have been the wrong decision. It is important, therefore, to analyze and contrast the potential profit that may be derived through total ownership or joint venture, with total potential license income and risks.

The greatest hazard for the licensor, as I see it, is that he may set up a competitor. The licensee's technological improvements and marketing ability may outstrip those of the licensor during the life of the license, which may then permit the licensee to become a dominant factor in the market subsequent to the expiration of the patent.

On the other hand, there are instances in which a licensee has paid such high fees and royalties for know-how that he might have been better advised to have spent the funds on research, people, and facilities to improve his own product or process.

To summarize: It is my opinion from a financial viewpoint that as a *first choice*, a well-heeled, competent manufacturing company, as contrasted to a purely research oriented company, should retain its know-how and apply it in its own plants or in wholly owned subsidiaries, domestic or foreign, and generally license to others only those things they are not qualified to manufacture or market.

As a *second choice*; in most cases a joint venture seems to me to be a safer and more desirable course for a small, manufacturing company to take than to grant a license to another company.

Mr. Stobaugh, in his commentary, also points out that retention and ownership of know-how is "... theoretically permanent, while licensing is limited to a set period of time." This viewpoint was further supported by a statement Mr. Stobaugh attributed to Mr. Morrison, Vice President of Hooker Chemical Corporation: "In ten years, the usual time of licensing agreements, you have a competitor — not a partner."

Thus, in closing, all of the considerations I have

outlined, plus the points raised by this morning's speakers, are dependent upon several basic company objectives.

First, is the company's principal business the selling of licenses based upon its research, engineering and development expertise and facilities, as was Universal Oil Products Company's objective for so many years? If so, then licensing is its business, and it must increasingly be dependent upon a continuing flow of saleable know-how, or it will have to seek other business opportunities.

Second, in the more frequent manufacturing company situations, licensing may be less desirable than retention of full ownership, or some permanent ownership through joint ventures,

Third, if a company can or must improve its position technologically and competitively by becoming a licensee, then its principal decision will be based on the economic, tax, and legal aspects of the commitment and agreement.

Thus, the crucial management decisions overall appear to be about equally divided between objective, economics, resources, and dedication. One illustration of this comes to mind in the form of an alleged employee bulletin:

#### NOTICE

"The objective of all dedicated company employees should be to analyze thoroughly all situations, anticipate all problems prior to their occurrence, have answers for those problems, and move swiftly to solve those problems when called upon..."

"However . . . when you are up to your neck in alligators, you must remind yourself that your initial objective was to drain the swamp."

Thank you. I hope we have not left you so deep in "alligators" that you lose sight of the chief objective: PROFIT.

*\*About the Speaker: Arthur R. Cahill, Vice President-Finance and a member of the Board of Directors of Brunswick Corporation, has spent all of his business career in the field of finance. A native of Springfield, Missouri, he is a 1931 graduate of the University of Chicago where he was a letterman in baseball and basketball, and later served as president of that university's monogram club, the Order of the C, as well as president of the university's Alumni Association. After working for the Federal Reserve Bank of Chicago and the Harris Trust & Savings Bank in various capacities, he joined Montgomery Ward & Company in 1941 and rose to Vice President and Treasurer in 1948. He left Ward's in 1952 to join International Miners & Chemical Corporation as Vice President and Treasurer and in 1957, was promoted to Vice President-Finance and elected to that company's Board of Directors. He joined Brunswick in his present position in 1960 and was elected a director in 1961. He also is a director of Bradshaw-Praeger & Company and the Oak Park Trust & Savings Bank, and has served as a director of the Executive's Club of Chicago, the Illinois State Chamber of Commerce and the University of Chicago's Alumni Foundation Board.*