Introducing the *IAM* Finance Panel

With banks and other financial institutions taking a much closer interest in intellectual property, *IAM* has put together a team of experts that will help keep readers updated on key developments

By **Nigel Page**

Since *IAM* was launched in July 2003, interest in intellectual property as a monetisable asset has been growing steadily. Whether through securitisation and collateralisation, or via second-lien loans, hedge funds and private equity financings, a number of macroeconomic trends are combining to turn corporate and financial sector attention towards the latent value of IP portfolios – and the ways in which this value can be exploited. Fundamental to the successful execution of these deals is a robust and reliable framework for the analysis and valuation of IP; it is therefore no surprise to see IP valuation techniques becoming such a focus of attention.

In direct contrast to the situation a few years ago, when hype around IP finance deals outweighed genuine activity, we feel that now is the right time to provide a proper forum for debate. As a result, we have invited a number of experts in the field to join a Finance Panel (their names are listed in the box on page 45). This Panel enables us to tap into key developments in the area, providing us with a sounding-board for future articles and supplements. In time, we hope to initiate a series of round-table discussions among panel members (for publication in the magazine), as well as incidental seminars, breakfast meetings and themed events. We feel it is important to those in the finance industry – as well as to IP owners – that key individuals in the finance industry with an interest in IP should become a visible and accessible grouping.

To mark the launch of the Panel, we have invited a number of our panellists to provide us with their thoughts on key trends likely to shape deal-making in this area during 2006 and beyond. A cross-section of these viewpoints appears below.

Mike Herman
Vice president, royalty investments,
Royalty Pharma
Royalty Pharma provides liquidity to royalty owners, and assumes the future risks and rewards of ownership (www.royaltypharma.com).

Over the last 10 years, we have seen an increase in the number and size of royalty transactions, as well as the complexity of these deals. The number of transactions has increased significantly from a couple per year to over a dozen in each of the past three.

The reason for this escalation stems from several factors. First, there was significant focus on licensing efforts by institutions and biotechnology companies in the 1980s and 1990s, which are beginning to bear fruit in the form of product sales and royalties. From the pharmaceutical side, the model for getting new products to market has changed from a fully integrated one to one in which in-licensing has become the norm. In addition, the products on the market today (particularly biologics) are much more complex than in the past, with a variety of patents covering a single agent, increasing the likelihood that the IP is assigned to an entity other than the marketer, giving rise to a royalty. In sum, the number and amount of royalties has grown tremendously in the recent past. Average transaction sizes have gone from under US$10 million to tens of millions to US$50

IAM Finance Panel

Douglas Elliott – TEQ Development LLC
Duncan Moore – Morgan Stanley
Brian Feit – Ambac
Bob D'Loren – UCC Capital
Nir Kossovsky – Technology Option Capital
Bill McGinty – NASDAQ Insurance
Elliott Fishman – Astrina Capital
Malte Kollner – Triangle Venture Partners
Keith Bergelt – IP Innovations
Glenn Yago – Milken Institute
Mike Herman – Royalty Pharma
Karl Wilhelm – ipIQ
Elliott Hayes – AIG Direct Investment
Joe Agiato – Newlight Capital
Jim Malackowski – Ocean Tomo
Frank Cuypers – Swiss Re
Guido von Scheffer – IP Berwertungs
Pete Walsh – Harris Nesbitt
Bob Block – Johnson Higgins
Hideki Otsuyama – Intechstra
Jay Eisbruck – Moody's
Rob Kramer – Altitude Capital Partners
John Kwon – Duff & Phelps LLC
Susan Searle – Imperial Innovations

million to US$100 million, with the largest a US$525 million one we completed in July 2005 with Emory University.

Jay Eisbruck
Managing Director,
Moody's Investors Service Asset-Backed Finance Group
With the rapid expansion of the capital markets, Moody's (www.moodys.com) rating coverage in the corporate sector has mushroomed to encompass some 4,000 companies and more than US$2.5 trillion of outstanding debt. On the buy side, clients of Moody's consultative research services manage more than 80% of capital in the corporate markets globally.

The IP securitisation market is no longer in its infancy but it has not reached maturity yet. The broad categories of deals that can be done have been defined – ie film, music, trademark, patent, and franchise fees – but none of them have approached their full potential. Successful transactions in each of these areas have encouraged innovation but continued work by market participants is necessary to lift the asset class out of its current niche status. Recent developments have given signs that this may soon be the case. As production and marketing costs have risen in the movie business, most of the major studios are now looking to securitisation to transfer performance risk. On the other side of these transactions, sophisticated financial players have become comfortable with the risk in an industry previously known for its financial opacity. Other parties are now looking to use securitisation to finance large M&A transactions by capitalising on brand value. These deals are being done in amounts that would have been unheard of a few years ago. As more deals of this type are completed and become known, the IP securitisation market is poised to finally attract the significant IP owners that have neglected it to date.

Glenn Yago
Director, capital studies, Milken Institute
The Milken Institute (www.milkeninstitute.org) is an independent economic think-tank. Its mission is to improve the lives and economic conditions of diverse populations in the US and around the world by helping business and public policy leaders identify and implement innovative ideas for creating broad-based prosperity.

The creative use of financing to mitigate and divide risks is key to finding solutions to monetise intellectual assets, and to advance their application to solutions to human problems in medicine and health, the environment, education, information and communications technologies, alternative energy, housing, food and other growth industries of the 21st century. Right now, there are more good questions than answers, but the laboratory of the capital markets will carve a channel between the largest pools of investors in human history and solutions with higher yields. How is valuation a key feature of financial innovation and how do IP portfolios reduce valuation volatility in other industries? Is there a role for mezzanine players, hedge funds, other types of investors in this emerging IP market? Structured finance is key to addressing the range of intellectual asset capital challenges by defining and dispersing insurable risks. Structured finance and other types of financial innovations will provide the means of risk transfer most needed for financing IP-driven industries.

Karl Wilhelm
Vice president, mergers & acquisitions, ipIQ
ipIQ (www.ipiq.com) focuses on advancing patent-based IP as a measurable financial asset and tightly integrates IP into the corporate decision-making process.

The wide acceptance of patent portfolio securitisation and monetisation largely depends on the financial community's ability to have access to objective, proven evaluation metrics and tools. As an asset class, the value of a patent or patent portfolio is ultimately determined by its impact on commercially successful products and services. Relating patents to traditional business metrics requires the ability to determine those patents integral to developing, manufacturing and delivering a product or service. The measurement of both the impact and risk associated with the securitised asset will lead to these patents being securitised/monetised at the most advantageous terms to the owners, financiers and licensees. Financial institutions will ultimately provide competitive financing vehicles for patent-based assets, which are not readily available in the marketplace today. ipIQ expects that securitisation of this asset class will evolve significantly over the next two to five years, driven primarily by the metrics and tools that both industry and the financial community agree on as critical to assessing value.

Dr Frank Cuypers
Head of IP, Swiss Re
Swiss Re (www.swissre.com) is one of the world's leading reinsurers, operating through more than 70 offices in over 30 countries, and offering a wide variety of products to manage capital and risk.

Many corporations can barely afford the costs of creating a useful patent portfolio and do not have the resources to manage such a portfolio effectively. Raising capital for a technology, instead of for an entire company, may become alternative sources of funding. It would be interesting to see what role patent pools may eventually play in such a development.

In spite of the costs associated with defending or asserting patents, IP insurance has remained a dormant field. Maybe some impetus may rise from the compulsory scheme of patent litigation insurance contemplated by the EU Commission. It should provide legal funding for asserting granted European patents and is aimed at encouraging small entities to file more patents in the context of the Lisbon Agenda, which is to make the EU the world's leading innovation force by 2010.

IP securitisation, collateralisation and more complex SPVs are promising emerging methods for creating value out of innovation. The techniques can be borrowed from more mature products such as catastrophe bonds, but one of the main challenges still resides in a proper valuation. In essence these instruments generally boil down to swapping a variable and uncertain profit with a regular cash flow, and should therefore become the darlings of any CFO.

Brian Feit
First Vice President, Ambac Assurance Corporation
Ambac Assurance Corporation is a leading guarantor of municipal and structured finance obligations.

Historically, we've seen a number of different deals in this sector. There have been IP financings where organisations transfer their copyrights, trademarks and other intellectual property into bankruptcy remote special purpose entities. With these transactions, the two most important IP-driven objectives have been to ensure the IP is pristine and to isolate the IP properly in a bankruptcy remote structure. However, the financing amount for these transactions has either been based on projections of future cash flow or as a multiple of EBITDA. Subsequently, we've seen pharmaceutical royalty deals where the amount of permitted financing is usually correlated to the maturity of a portfolio of patents. Now the industry needs to push towards a more expanded role of IP in financing transactions. For this to occur, investors will need to continue to gain comfort that IP can be properly isolated and that cash flow generated from the IP can be reasonably estimated. It will also require CFOs to view IP similar to other assets on their balance sheet – as a source of value that can readily be monetised either through financings or other joint venture arrangements. When this mindset shift occurs, we can then expect a new phase of IP-based financings to materialise.

Joe Agiato
President, Newlight Capital LLC
Newlight Capital (www.newlightcapital.com) provides capital solutions to businesses with strong intellectual property positions.

The market has realised IP is an asset and in many cases the only real asset of an organisation. This realisation has been shown time and again, and certainly the recent settlement between Research In Motion (maker of the BlackBerry) and a small Virginia company called NTP for over US$600 million reminds us how technology, even for a company that does not have a product, can be extremely valuable. The credibility established has started the evolutionary process of developing financial instruments secured by the IP. At this point in time, I believe the harmonisation of cross-border protection has successfully established IP as an asset class. This has led to companies monetising their IP through the financial markets, most commonly through leasing, royalty securitisations and selling royalty streams. As the investment community begins to realise the inefficiency of the IP market, and becomes more comfortable with the asset class, you will see more investment in the underlying IP through various structures, where high equity-like returns are available with principal well secured.

Douglas Elliott
Founder, TEQ Development LLC
TEQ Development LLC is a licensor of business methods for intellectual property.

Glenn Yago
Milken Institute

"Structured finance is key to addressing the range of intellectual asset capital challenges by defining and dispersing insurable risks"

Joe Agiato
Newlight Capital LLC

"The harmonisation of cross-border protection has successfully established IP as an asset class"

Nir Kossovsky
Technology Option Capital

"Future value is concentrated in companies and in industries that are built on intangible assets"

I foresee three trend dynamics for IP summarised as follows: range wars over patentable subject matter; the rise of bankers and decline of lawyers in IP management; and the displacement of western suburbia and the rise of the east and the southern hemisphere as the strategic drivers for IP innovation.

Range wars refer to the growing conflicts among developed and developing nations, entrepreneurs and corporate giants, academia and inventors over what should be the permissible private property rights in useful knowledge. As conflicts go, expect shifting alliances that will look more like Europe's Wars of Religion than World War II. Because IP litigations have been so successful in developing a consistent pattern of big value for valid patents, it is inviting bankers to begin to finance them. Unfortunately the predatory skills of IP litigators that successfully proved the value of IP will be anathema to financiers seeking to use IP as a stable, knowledge economy asset. Finally, the needs of the emerging economies in India, China, Latin America and Africa will be the growth opportunities of the 21st century. They will also set the agenda for what constitutes useful innovation. American suburbia, which for 60 years has defined the marketplace for the next new thing, has become saturated if not irrelevant. Instead, India's and China's crowded urban sprawls and remote rural villages provide a more relevant laboratory from which new invention and brand identity will emerge.

Elliot Fishman
Founder and president, Astrina Capital LLC
Astrina Capital (www.astrinacapital.com) is a technology merchant bank specialising in valuation and transaction advisory of IP.

The proliferation of these deals remains an unfulfilled promise. Four or five years ago, people said that IP would be the next big class of asset-backed securities, but this has still not happened. Currently, neither the number nor the size of these deals is developing – so why is this? Key factors include: the relatively small size of the asset class; the lack of harmonisation on deal terms; and the fact that licensing is handled by technology managers, not trained finance professionals. This last point is especially significant. If these deals are to happen, the principals have to understand what is involved. And for the moment, this is not happening. A lot of education is needed to move the market on.

Pete Walsh
Managing director, co-head of origination and structuring, US securitisation group, Harris Nesbitt
Harris Nesbitt (www.harrisnesbitt.com) provides asset-backed securitisation services in the US market.

There's plenty of cause for optimism right now. For instance, last September's US$525 million Marvel Enterprises deal showed what can be achieved. Marvel used a non-recourse debt facility to finance the production of up to 10 films based on its comic book characters, pledging the theatrical film rights to the characters as collateral for the loan. The deal, which was wrapped by Ambac and rated by Standard & Poor's and Moody's, provided a high-profile success story for others to follow, but there is a long way to go.

The market still needs educating where IP-backed deal structures are concerned, including the various options available depending upon the size of the deal, the characteristics of the collateral and the motivations of the client. IP will become a form of collateral that is more accepted than it is today as investors get more comfortable with it and issuers better understand the benefits of using IP as a form of accessing the capital markets, whether through second lien loans, hedge fund advances, bank loans or securitisations. As private equity sponsors are completing more transactions in the sectors of media content, retail brands and franchises, securitisation will play an increasing larger role in the financing of these acquisitions.

Dr Malte Köllner
Partner, Triangle Venture Capital Group
Triangle (www.triangle-venture.com) specialises in the development of high-tech companies with an emphasis on software and physical technologies growing out of German universities.

Some aspects of intellectual property, particularly patents, will attract an increasing amount of attention from now on. The potential for generating licence income from these assets – and the threat of infringement – is one key area. Another is freedom to operate – that is, the likelihood of a third party demanding licence fees for its patents (investment decisions in the venture capital industry are already influenced by a remarkable increase in freedom-to-operate awareness). Patent infringement suits will concentrate on damage and licence fees rather than on injunctive relief. Licence income-based deals will probably increase, probably following the Qualcomm model. In the years to come, patent portfolio management (or simply: patent work) will increasingly focus on return on investment for money spent, first for the patents and second for R&D. Here IBM has set a landmark. In terms of new financing vehicles, dedicated funds for patent exploitation have already been launched in Germany, even in retail, and we expect to see more of these.

James E Malackowski
President and CEO, OceanTomo LLC
OceanTomo, LLC (www.oceantomo.com) is a merchant bank specialising in understanding and leveraging intellectual property assets.

The most interesting development in the field of IP finance is that there is no single most interesting development. More specifically, the market is developing at the equivalent of a grass-roots level across all components of the capital structure – venture, private equity, mezzanine debt, credit-enhanced senior debt, securitisation, structured finance and public equities. The one common underpinning to all activity is the value of the asset in the appropriate secondary market, whether that is, for example, enforcement litigation, public auction or something else. The firm that best understands the core valuation metrics and has access to a range of markets and finance structures will do well.

Nir Kossovsky
Founder, president and CEO, Technology Option Capital LLC
Technology Option Capital (www.tocllc.com) is an intellectual asset boutique specialising in complex monetisation strategies.

Today, nearly 60% of the aggregate value of the US stock market is based on investor expectations of future growth. Because this future value is concentrated in companies and in industries that are built on intangible assets, it is critical to discover, realise and protect the value of these assets. The strategic direction of this actionable imperative comprises Heisenberg-like attributes. To the extent that intellectual assets create the opportunity but not the obligation to capture above average rents for goods and services, the assets exhibit the financial properties of call and put options. To the extent that intellectual asset management is costly and deploying intellectual assets invites a host of legal challenges, the assets exhibit the financial properties of strategic risks that need to be hedged. At Technology Option Capital ("Topcap"), we see the following emerging from the Heisenberg-like nature of intellectual assets: (1) M&A intellectual asset assessments comprising value and risk models; (2) hedged intellectual asset transfers in the form of synthetic licences; and (3) an emerging intellectual asset equity derivatives market.

Hideki "Eddie" Otsuyama
President and CEO, SBI Intechstra Co Ltd
SBI Intechstra (www.intechstra.com) is a Tokyo-based company specialising in intellectual asset business management, system solutions and consulting.

Ever since the first patent securitisation deal led by the Ministry of Economy, Trade and Industry (METI) in 2003, discussions among IP/finance experts have centred mainly on structuring finance schemes and valuing IP assets so as to develop Japan's technology-based finance market, still only a small segment of the total financial market. While the government has enacted legislation over the last few years that enables more flexible schemes for IP-based financing, various operational difficulties have continued to hamper significant growth in this market. Compared with content-based IP (copyright), technology-based IP (patent) cannot easily be valued independently from the business operation itself. Accordingly, most Japanese IP financings have been structured as loans or securitisations based on royalty inflows fixed by enforceable IP licensing contracts. Now, however, executives in many Japanese technology-rich companies (particularly SMEs) are interested in more flexible, functional and realistic structures for technology-based financing, as well as wanting to explore the possibilities for strategic IP management that will help them to improve their overall corporate value.

Rob Kramer
Managing partner, Altitude Capital Partners
Altitude Capital Partners (www.altitudecp.com) is a private investment firm that provides

Eddie Otsuyama
SBI Intechstra Co Ltd

"Executives in many Japanese technology-rich companies (particularly SMEs) are interested in more flexible, functional and realistic structures for technology based financing"

Robert J Block
Johnson & Higgins

"Intellectual assets are inherently associated with two major risks: first party and third party"

capital for intellectual property owners, corporations and law firms.

The relationship between injunctive relief and the value of IP is very much in the spotlight in the US. Currently, if you can prove infringement of your patent in a final decision, you are automatically entitled to an injunction against continuing infringement. Patents at their core are a right to exclude, so eliminating this right could have an impact on the ultimate value of intellectual property. These injunctions can, in extreme circumstances, shut down products or even the companies that manufacture them. However, two recent cases – *NTP/RIM* and *eBay/Merc-Exchange* – indicate that governmental agencies and the judiciary branch are further examining the automatic granting of these injunctions. In *NTP/RIM*, the USPTO is poised to reject the patent validity already established by the Federal Circuit decision as well as the jury in a district court trial. By agreeing to hear the *eBay/Merc-Exchange* case, the Supreme Court has indicated that it wants to revisit settled law established in 1908. The results in both cases could meaningfully affect how the market for intellectual property develops in the years to come.

Bob D'Loren
President and CEO, UCC Capital Corporation
UCC Capital Corp (www.ucccapital.com) is engaged in the direct origination of highly structured loans, typically backed by intellectual property or contractually obligated income streams. UCC also acts as a principal equity investor in companies with core assets in intellectual property in industries such as apparel, footwear and franchising.

From a debt perspective, there's a problem of perception. The market for IP-backed lending is actually much larger than is currently being reported. This is because there is generally a substantial IP element to many of the transactions that are getting classified as enterprise value or cash flow loans in the hedge fund sector. Today in the market, people find it hard to get their arms around what is being advanced against intangible assets, and what is being advanced against enterprise value or cash flow. I would say that between 10% and 20% of hedge fund Term B lending in the US last year was advanced against intangibles in some way (between US$1.2 billion and US$1.4 billion). On top of that, lending advanced against IP in the structured finance sector was well in excess of US$1 billion.

Robert J Block
JD, Johnson & Higgins
Johnson & Higgins offers finance and investment advisory, risk management & insurance, and consulting services.

From our perspective, intellectual assets are inherently associated with two major risks: (1) first-party, in which the ability of these assets to create cash flow and maintain enterprise value is impaired; and (2) third-party, in which the asset owner will pay catastrophic damages or will have its business model/operation burdened by the unanticipated assertion of IP rights. This spectrum comprises a risk portfolio that has both an upside and a downside. Portfolios with these types of financial property can be structured to enable efficient risk transfer to the capital markets. Among the intellectual asset risks currently held by companies that we see being transferred in the near future are: (1) brand impairment due to events in an iconic company's supply or distribution chain; (2) unreasonable tax liabilities due to opacities in international transfer pricing; and (3) enterprise value risk due to patent assertion.

Guido von Scheffer
Director, sales and organisation IPB AG (IP Bewertungs AG)
IPB AG (www.ipb-ag.com) helps companies, especially SMEs, to use their patent portfolios as collateral.

Apart from a patent's direct use as a legal right, a patent's indirect use is coming more and more into focus. Dealing in knowledge is no longer the preserve of big businesses such as IBM and Pfizer; small enterprises with highly focused patent portfolios are increasingly winning out in big-ticket litigation. Due to their external commercialisation, patents are increasingly recognised as an individual asset class. To invest successfully in patents, however, the major hurdle of market non-transparency must be overcome. Thus far, the significant costs of exploitation have proved prohibitive, preventing most investors from accessing this asset class. Having identified, or even owning, a high potential portfolio does not necessarily guarantee the anticipated revenues or royalties. In most cases, an initial investment is needed to find the perfect licensee – an outlay which the patent holder is rarely willing to make, due to the uncertainty of its licensing activities. An efficient exploitation process, combined with a structured commercialisation process, will offer investors interesting opportunities to access patent assets. While international technology transfer markets continue to lack transparency, investors can gain surplus returns on their investments, if the necessary infrastructure is offered as a one-stop solution by professional intermediaries.

Guido von Scheffer
IPB AG

"Small enterprises with highly focused patent portfolios are increasingly winning out in big-ticket litigation"

Keith Bergelt
President and CEO, IP Innovations Financial Services Inc
IP Innovations Financial Services (www.ipinn.com) provides funded loans and unfunded credit enhancements to allow royalty and non-royalty generating patents, trademarks and copyrights to be used as collateral in corporate financing opportunities.

As we move into an era of unprecedented innovation and, at the same time, witness increasing levels of pressure from shareholders on corporate research and development budgets, senior leaders must find ways to distil greater value from investments in technology and the intellectual property that underpins it.

While the most sophisticated of IP-intensive firms have been actively engaged in traditional attempts to secure value from IP, including core and non-core licensing, cross-licensing and utilisation of IP for equity swaps into promising technology start-ups, in recent years a move has been made to explore financial solutions that further leverage core investments in IP. These approaches include asset-based securitisations, where IP serves as the underlying asset to be securitised, and asset-based lending, where IP serves as the sole source of collateral for a loan. Asset-based securitisations rely on cash-flowing IP and utilise tried and true structures that have been used in mortgage-backed securitisations for many years. In the myriad of cases where IP does not generate discrete revenue streams, IP collateralisation offers a highly effective vehicle to maintain ownership and use rights in IP while facilitating access to much-needed growth capital. ■

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