Financing intellectual property

For companies seeking to leverage their IP assets in the financial markets there have never been more products on offer. The trick is to find which one is most suitable

By **Ariel Glasner**

In the last decade, companies that historically manufactured and distributed their own products have begun to outsource their means of production and create value instead by building their brand name. This trend has resulted in traditional supply chain companies re-engineering their businesses so that they are based on value net models, thereby eliminating inventory and production risk, focusing on leveraging brand capital and creating consumer brand loyalty.

A supply chain operating model centres on production and the means of production. This model is working capital intensive and represents an inflexible operating structure that leaves a company unable to react quickly to market changes. In most cases, the kinds of companies following the supply chain model push their products onto customers by spending money on trade promotions and acquiring shelf space in order to capture customer interest. As digital technologies such as the internet supplant companies as the gatekeepers of product information, consumers can make increasingly informed and independent purchasing decisions. The model is also being challenged by a shift of power away from the manufacturer to the retailer. In recent years, retailers have increased their margin requirements. Those companies that remain trapped in a supply chain operating model will most certainly see revenues and margins decline.

The value net model, on the other hand, allows companies to be flexible by forming a strategic alliance between distribution channels and third-party manufacturers of products. In this model, production is outsourced to the most efficient and lowest-cost manufacturer while customer acquisition is delegated to those entities that are closest to the consumer, the retailers. By outsourcing production and revamping product distribution, value net operating companies are comprised principally of their intellectual property assets, and their ability to succeed depends on their brand strategy, product design, quality standards and responsiveness to consumer trends. Instead of pushing their product into the market, value net companies are designed to focus on building brand awareness and loyalty, and on engaging customers to provide their input into product development. In this scenario, customers demand value net companies' products on store shelves or pull them through distribution channels.

A bevy of data supports the assertion that companies are switching to value net models and are making their IP assets the central component of their businesses. For example, technology firms are increasingly relying on a licensing platform to succeed. In 1980 patent royalties in the US reached only US$8 billion annually. By 2004, that number had increased by over 18 times to US$150 billion, and patent royalties continue to rise. Similarly, franchising has become a US$1 trillion industry in the US. Sectors that did not previously operate on a franchise model, including hospitals and estate planning, are adopting this way of doing business in part to better cater to the ageing baby boomer population.

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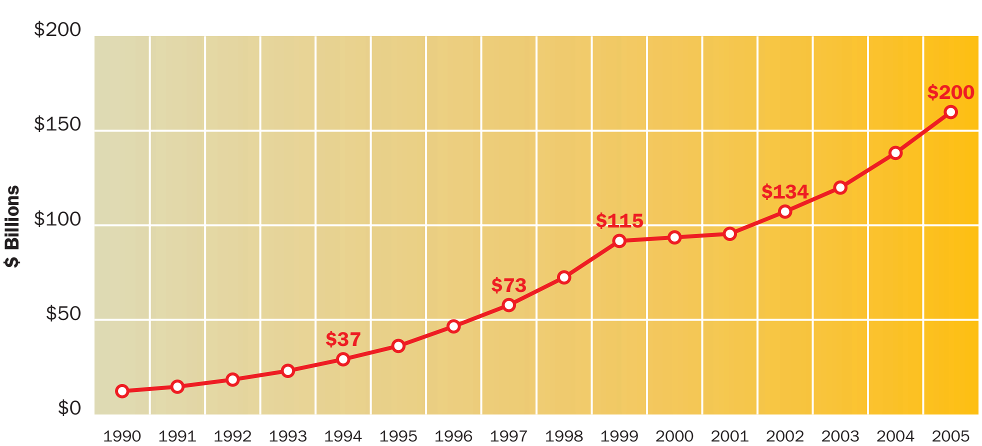
As a result of these economic trends, many companies are seeking ways to monetise their IP assets. Traditional asset-based lenders cannot meet this demand, though they generally assume a lien position on the borrower's IP in addition to inventory and receivables, because little to no credit is given to what is generally considered to be an intangible asset. For companies that have core assets in IP, one common alternative to an asset-based loan is to secure a standard corporate bank loan. Such a loan will credit the borrower's IP assets, but it comes at a significant cost. For instance, the loan is usually full recourse, meaning that the borrower must risk its entire creditworthiness in order to secure it. Furthermore, because of the perceived risk of lending against IP assets, such bank loans are offered only for short terms at steep interest rates.

Within the last 18 months, however, several additional financial products have come to market that have attempted to provide a sustainable financing solution for IP-centric companies. The first such product is a form of credit enhancement that insures the payment of the corporate bank loan. A third-party credit supporter can guarantee payment of all or a portion of the loan, which in turn lowers the lender's perceived risk and the loan interest rate. As long as the fees charged by the credit enhancer are lower than the savings achieved by insuring the bank loan, this type of transaction is a win-win for both the borrower and the lender.

Another product that has emerged is a type of security already popular in Canada known as income deposit securities (IDS). IDS are structured by combining a subordinated note with a common equity security, so that investors receive both a regular dividend payment on their equity portion and a fixed debt service payment to satisfy the subordinated note. IDS can be used to monetise intellectual property assets that generate cash flow in the form of royalties and they are attractive from an investor standpoint because they have the ability to boost the investor's return on investment. Nevertheless, they have met with little success in the marketplace.

The principal reason behind borrowers' reluctance to structure IDS in the United States relates to the issue of entity pass through taxation. The US tax code permits debt interest payments to be tax deductible at the company level, while dividend payments are taxed both at the company level and at the shareholder level. As a combined debt/equity instrument, the eligibility of the subordinated note interest payments to be tax deductible has yet to be fully tested, and as a result companies are wary of undergoing the complex and lengthy structuring process required to access this type of capital.

Annual US patent licence royalties



Source: *Washington I CORE*

Second lien lending

Following 2001, borrowers faced an unfriendly debt market due to a limited amount of capital and to lenders' considerable aversion to assuming risk. In 2004, however, the closed spigot impeding the debt market was turned on, leading to a veritable flood of lending. One catalyst for the shift was the new presence of hedge funds in traditional debt markets. Hedge funds' access to virtually unlimited capital, and their desire to put it to use, has led to more debt on borrowers' books, and to traditional lenders easing their thresholds.

This trend has also led to a new category of secured lending facility that enables companies to leverage their IP assets through second lien or term B loans. Previously, a subordinate debt lender assumed a second or subordinate lien to senior lenders, requiring senior lenders to be fully paid out in the event of a liquidation scenario before receiving any recovery. A mezzanine debt lender assumed an unsecured position, but was rewarded in the event of liquidation ahead of any equity sponsors. Both of these forms of debt are restricted by the senior creditor's right to block sub-debt payments and to require turnover of any collateral received from the borrower to the senior lender, in the event of bankruptcy. In contrast to these two forms of financing, hedge funds sought to take a shared position within senior lenders' first lien, that would only require turnover to senior lenders of any shared collateral, and would not allow for payment blockage provisions. This idea became the foundation for second lien lending.

Two principal forms of second lien transaction structures exist. In a traditional second lien structure, the senior lender assumes a blanket lien on all assets, while the junior creditor assumes a second lien position. In the event of a bankruptcy, the senior creditor's debt is satisfied first, then the second lien holder, and then subordinate debt, mezzanine, unsecured debt, preferred stock holders and lastly common equity.

Alternatively, in a bifurcated second lien structure, the junior creditor can take a first lien position on a specific class of assets. In certain transactions, the senior asset-based lender will only hold inventory and receivables as collateral. In this case, the second lien holder can actually assume a first lien position on the intellectual property assets of the borrower as well as on some fixed assets, such as plants, property and equipment. In the event of bankruptcy, the term B lender will carve out the real estate and IP assets, and the senior creditor will be satisfied through the liquidation of inventory and receivables.

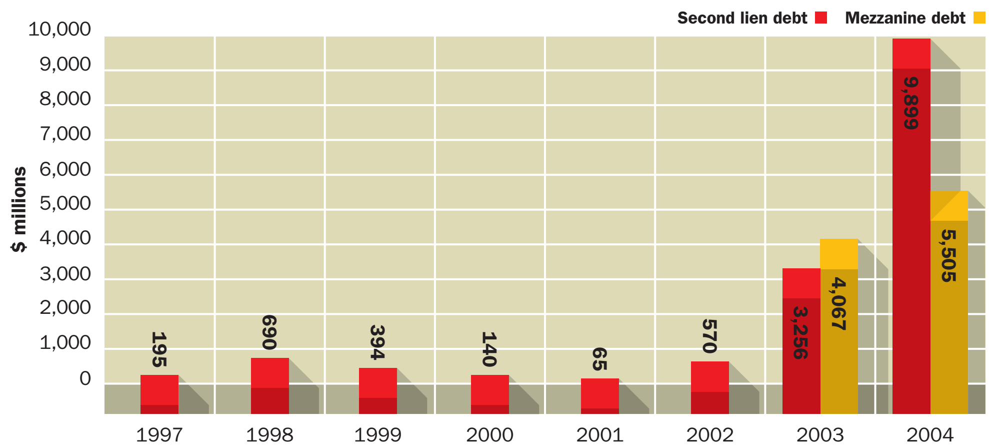
As a result of this new funding vehicle, traditional asset-based lenders who specialise in collateralising inventory and receivables are establishing strategic partnerships with hedge funds and other financing sources in order to become one-stop shops for lending. In doing so, senior lenders are able to more easily negotiate the inter-creditor agreements that are critical to preserving the integrity of second lien loans with the junior creditor. Overall, however, the rise of term B loans has proven to be most beneficial to borrowers. The flood of capital from hedge funds has led to stronger competition among funding sources. Lenders will now consider debt ratios that were virtually unthinkable a year ago in order to snag a client. Pricing spreads and profit margins are also facing downward pressure. Whereas mezzanine lenders succeeded in providing capital at a 16% to 17% coupon, without warrants, second lien lenders provide capital for as low as an 8% coupon.

In addition to facing an extremely competitive market, term B lenders must also tackle the issue of appraising the IP that is being secured. This decision is made based upon the nature and quality of the IP. For instance, IP that is generating revenue through licensing royalties can be valued, at least in part, through a discounted cash flow analysis. Often, however, royalty income is not associated with the IP in second lien transactions, and lenders must therefore calculate another means of valuing the assets.

MacGregor Golf Company recently secured funding through a second lien transaction by obtaining a US$12 million senior revolving line of credit backed by its inventory and receivables, and an US$18 million loan collateralised by its intellectual property. Despite having a well-recognised brand name, the company did not have a licensing platform tied to its trademarks, making it more difficult to determine their value.

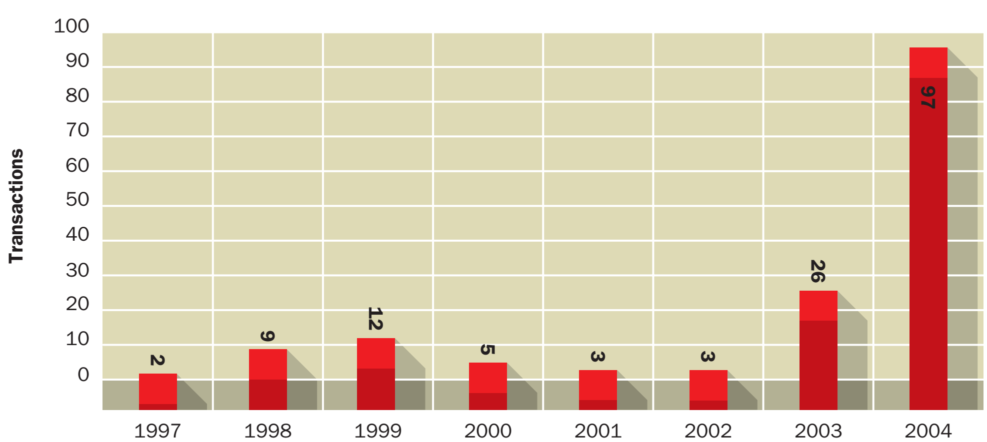
Ultimately, MacGregor's IP was appraised through a variety of methods, which included examining sale comparables of the assets, analysing the investments made by the company into the drivers of the trademarks, such as marketing and R&D, and assessing the impact that the company's trademarks have had on the company's bottom line over time. Employing a variety of methods to value IP is not unusual in the second lien market. However, in order to be able to appraise the IP correctly and to ensure that it is being effectively leveraged, lenders must build expertise in understanding how IP works and must approach IP from a different perspective than they would other fixed assets.

Second lien loan volume 1997-2004



Source: *CIBC World Market*

Second lien loan transactions completed 1997-2004



Source: *CIBC World Market*

Whole company securitisation

The most effective form of financing for IP-centric companies is one that has actually been available since 1997, and is known as a whole company securitisation (WCS). WCS enables IP holders to gain liquidity in an innovative way by leveraging their copyrights, trademarks, patents or other forms of contractually obligated income. This process generates higher levels of capital relative to other types of financing by creating asset-backed securities (ABS) collateralised by IP.

To complete such a transaction, the IP owner assigns and transfers the IP and any associated contracts or licensing agreements to a limited-purpose bankruptcy-remote vehicle (SPV), an affiliate of which issues securities backed by the assets. A franchisor, for example, moves its trademarks and associated royalty contracts into the SPV. Similarly, branded apparel companies move their trademarks and third-party licensing agreements into the SPV, and technology companies assign their patents to the bankruptcy-remote vehicle. Most significantly, this senior debt instrument enables the borrower to issue debt up to five notches above its underlying corporate rating, thereby significantly lowering its costs of capital.

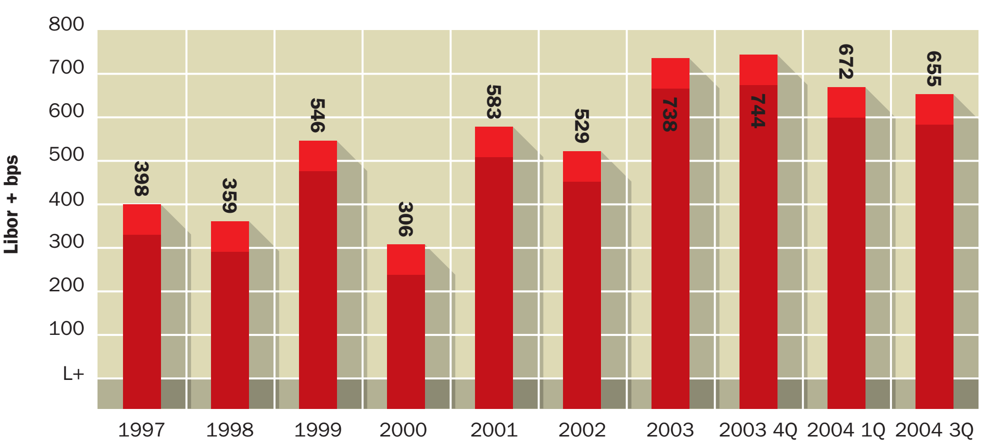
Accessing capital through a WCS is ideal for companies in industries such as branded consumer products (footwear, apparel and sporting goods), franchising, media and entertainment, technology, telecommunications and pharmaceuticals. All of these industries are characterised by their concentration of intellectual property assets and contractually obligated income streams. WCS funding can be employed for a variety of purposes, including refinancing of existing debt, facilitating a management buyout or firm restructuring, or as an acquisition vehicle. Transaction sizes range upwards of US$20 million, so a WCS is generally not an option available to small-sized firms. The buyers of the bonds that are issued by the SPV are typically institutional investors such as insurance and reinsurance companies.

In order to qualify for a WCS, the issuer must meet several criteria. Because a WCS is non-recourse to the borrower's other holdings, the IP assets that are being collateralised must be able to generate sufficient cash to satisfy annual debt service, and they must have an operating history of at least three to five years. Consequently, this type of financing is not considered a substitute for mezzanine, venture or start-up capital. Furthermore, the contracts and licensing agreements associated with the IP assets must be portable and assignable, which means that they must have a cash-flow generating potential outside of the operating entity. For example, a trademark whose ownership is divided among multiple parties may not be assignable if all parties are required to give their prior consent to the transfer of any licensing agreements into an SPV.

Companies that are interested in accessing capital through a WCS can make the process easier by preparing in advance. They can do so by reviewing their royalty income contracts, whether those be in the form of licensing agreements, franchise agreements, patent royalty contracts or other forms of contract, in order to assess the length and revenue potential of each contract. Companies should also identify their capital need well ahead of time, as the securitisation process can take six to nine months and includes extensive due diligence on the assets, achieving a bond rating through Moody's or Standard & Poor's and securing a legal true sale and non-consolidation opinion to transfer the IP into the SPV.

Within the past five years, nearly two dozen WCS transactions have been completed. Most recently, the apparel company BCBG/MaxAzria issued bonds backed by its trademarks and third-party licensing agreements in December 2004. Following 11th September 2001, the company experienced a dramatic decline in sales and was unsuccessful in raising capital at an optimal price through the mezzanine debt or equity markets. Over the course of two years, the company expanded its licensing portfolio in order to generate additional revenues, and then raised liquidity to recapitalise and refinance a working capital line through a WCS. Another successful

Average spread of second lien loans 1997 – 2004 3Q



Source: *CIBC World Market*

transaction took place in 2003, when the Athlete's Foot franchise system issued bonds to facilitate a management buyout of the franchise operations.

The success of WCS is underscored by the pitfalls that companies face when attempting to monetise their IP without properly structuring or underwriting such a transaction. A WCS requires all current and future IP assets to be transferred to the SPV, and to provide for sustaining the drivers of those IP assets. These drivers can include R&D expenditures, advertising, PR and marketing, employee training and information technology. They are monitored and maintained through a WCS by ensuring that the borrower funds these drivers ahead of its debt service payments. WCSs cannot be realised by simply transferring a select few IP holdings of the company into a bankruptcy-remote vehicle that issues securities, in part because of the danger that the cash flow associated with those specific IP assets will dry up.

The Zerit lesson

Perhaps the most notorious example of this scenario took place in 2000, when Yale University securitised its licensing royalties from the FDA-approved pharmaceutical drug Zerit, used to treat HIV and AIDS patients. Zerit generated royalties for Yale through an exclusive licence to Bristol-Myers Squibb. Royalty Pharma structured the transaction and obtained a single A rating for the bonds issued by the SPV, BioPharma Royalty Trust, from Standard & Poor's. S&P's rating was assessed based on Zerit's sales forecasts and both Yale's and Bristol-Myers' high credit rating. As a result of the securitisation, Yale received a US$100 million liquidity boost to construct a new medical facility.

By late 2002, the A-rated bonds issued by BioPharma Royalty Trust had defaulted as sales of Zerit plummeted. While the immediate cause of the default can be traced to Bristol-Myer's decision to sell off its inventory of Zerit to wholesalers at a discount, in retrospect the transaction was doomed from the outset. Perhaps most importantly, the financing failed because only a single patent was transferred into the SPV instead of completing a WCS. Royalty Pharma also elected to complete its own valuation of the patent, instead of hiring an independent and impartial third-party valuation firm, which led to an approximately US$400 million overvaluation of the asset.

In addition to its valuation, Royalty Pharma made a critical mistake by failing to understand properly the nature of the leveraged IP asset and the distribution channels through which it was sold. Compared to other forms of intellectual property, patents of technology and pharmaceuticals are susceptible to becoming obsolete over a short period of time. Therefore, in order to ensure a stable stream of royalty income until the bonds are fully amortised, a structuring agent should only consider securitising a portfolio of diverse patents and fully take into account the IP drivers that create the value in such patents. Even though copyrights and trademarks may not share the obsolescence risk of patents, the same lesson derived from the Royalty Pharma transaction applies. Generally, in WCS transactions consideration must be given to concentration limits. For example, in apparel transactions the percentage of royalties derived from any one licensee must be analysed, and, similarly, in franchise transactions the percentage of royalties flowing from any one franchisee must be examined.

By taking a conservative approach to the risks involved in a securitisation, all the parties involved in a WCS – the borrower, the institutional investors and the structuring agent – will benefit, and will help to ensure the future of whole company securitisations in the marketplace. As business and economic trends continue to favour the development and ownership of intellectual property assets, WCS will become the standard bearer for a range of financing options that companies can seek to efficiently leverage their holdings while maximising their balance sheet. ■

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