IP debt – the new monetisation option

IP debt is a new way to raise cash from patents without having to sell or enforce them. However, it can be a high-stakes game and companies need to take care that they do not lose control of valuable intellectual property

By **Joseph W Jennings**

The IP industry has been trying to monetise patents for the last decade – buying and selling, enforcing and licensing – to generate cash and competitive advantage. Including IP portfolios as part of a larger corporate debt deal, usually tied to accounts receivable and inventory, has been standard practice for some time. However, what is new and emerging is borrowing that uses IP assets exclusively. This article looks at the emergence of IP debt as a new monetisation/capitalisation strategy and offers insights on how to raise cash without diluting, selling or losing control of your IP assets.

"We need to raise capital and would like to use our IP portfolio as collateral in a debt deal," said the president/CEO of a later stage technology start-up. "Equity is expensive; other forms of debt do not fit our situation; and we do not want to enforce or lose control of our patents. Can we take the patent portfolio that we have built and borrow against it?"

The basic question is whether there is a third way to generate cash from IP assets besides enforcing the assets or selling them to a third party. Until recently, the answer has been no. Now, the answer is maybe.

Current choices for raising cash from IP assets

IP debt is a short-term (between two and three years) loan that is secured primarily or only by a company's IP assets. During the period of the loan, the IP assets are encumbered by a lien that prevents them from being enforced, reassigned or sold without the lender approving and releasing the lien.

In a traditional corporate debt deal, IP assets are often pledged along with accounts receivable, inventory and cash. Traditionally, intellectual property is just one of the several types of asset that a lender seeks to secure to reduce the risk if a borrower should default on a loan. In most cases the actual value of the IP assets is perceived as minimal and very risky, and therefore such assets are heavily discounted.

Fundamentally, what differentiates an IP debt deal from other forms of corporate debt is that the IP portfolio is the main asset being secured against the debt. The amount of the debt is calculated on the value of the IP portfolio, and the primary remedy for the lender if the debt is not repaid is ownership of the IP portfolio being used as collateral.

Why is IP debt becoming more popular?

There are three reasons why IP debt is becoming more popular:

- The expertise for assessing IP risk and value is becoming more readily available.
- Some IP assets have increased in value.
- The capital is available to lend.

Expertise

IP debt is emerging as a new business opportunity for non-practising entities (NPEs) and new market entrants because the infrastructure needed to analyse IP assets for enforcement is the same as that needed to value IP assets for lending instruments.

"We are looking at how to increase the types of opportunities we can address with our infrastructure," says Jonathon Skeels,

Figure 1. **Current choices for raising cash from IP assets**

Enforce IP assets
- Requires evidence of use
- Five-year time horizon
- Significant upfront costs
- Significant risk to organisation
- Retains ownership of IP assets
- Possible high return

Sell IP assets
- Requires evidence of use
- One-year time horizon
- Low upfront costs
- Low risk to organisation
- Loses ownership of IP assets
- Range of deal structures, from all-cash to back-end revenues

Borrow against IP assets
- Requires evidence of use
- Three to six-month time horizon
- Low upfront costs
- Low risk to organisation
- Retains ownership of IP assets
- Requires payment of interest and principal within two to three-years

Figure 2. **Merging NPE and corporate lending expertise**

vice president of finance and business development at IP Navigation Group and IPNav Capital. "Debt can be attractive as a business for us because we can generate returns on our loan's interest and warrant coverage. It also enables us to generate more business with the infrastructure we have built for patent acquisition and enforcement."

It is as if a traditional corporate lender was merged with a sophisticated IP company. The former assesses the financial and operational risk of lending to a company, and the latter assesses the value and risks of the IP portfolio.

Asset value

The underlying value of some IP assets has soared in the last five years. This rapid increase means that companies which previously raised debt only on their accounts receivable or inventory may now tap their IP assets as collateral. Additionally, there are many growth and late-stage companies with substantial patent holdings that have not raised equity capital in the last 24 months. They have found it difficult to raise either further rounds of equity or more debt. Such companies are good candidates for taking advantage of the IP borrowing opportunity.

"The run-up in IP asset values applies to only the strategic assets, not all IP assets," says Michael D Friedman, managing director, Ocean Tomo, Investment Practice. "The IP debt market is available to a subset of companies and portfolios that own strategic, enforceable assets. It is not open to everyone who owns patents."

Availability of capital

The capital fuelling the IP debt market is primarily private equity and high-net-worth individuals seeking higher returns. The higher expected returns from IP lending can come from either outcome: loans are paid with reasonable interest and warrant coverage; or the loan is not repaid and the assets are either sold or put into enforcement and the lender enjoys the upside.

These factors, combined with licensing and enforcement expertise, enable the IP debt market to become a new source of capital to companies. However, this new avenue comes at a price: it is more expensive than other forms of debt because it is potentially riskier compared to accounts receivable and inventory.

Why borrow using intellectual property?

"For certain types of companies it is a better fit with their business plans and their stage of development to borrow against their IP assets than to seek either to monetise their patents through enforcement or sale, or to raise equity capital," says a leading IP monetisation executive.

There is one fundamental question: do you want to monetise or leverage your IP assets? The path will be very different depending on which you choose.

A decision to monetise leads to the next question of whether to enforce the IP portfolio yourself or sell the assets, either to someone that will enforce them or to an operating company that will use them defensively. Enforcing the portfolio could yield significant returns, but is a multi-year commitment, and the results are anything but certain. Selling the assets generates less cash in a far shorter period of time, and provides a grant-back licence and possibly a back-end revenue share, but the assets are no longer in your control and are unavailable for defensive purposes. Leveraging the assets with IP debt allows the borrower to retain control of the assets and raise capital for a limited period of time, but creates a cash obligation to pay back the capital with interest.

"For some start-ups and later stage companies, their IP portfolio is their largest asset, and raising capital or selling them is not an option or too expensive," said Ron J Epperson, managing director of Intellectual Energy LLC. "The key two factors are then IP valuation and ability to repay the loan."

Borrowing against a company's intellectual property is inherently more difficult and riskier than borrowing on accounts receivable or inventory – hence the steeper cost. However, this may be justified given the downsides or lack of availability of traditional means of raising capital, including:

- Raising equity. With this option, the current investors suffer dilution, and this may be a bad time for the company to go out seeking new investors or tap existing investors for new rounds of capital.
- Raising debt from accounts receivable and/or inventory or other assets. This may prove difficult if the company has insufficient revenues or inventory to borrow against.

Some companies have a large patent investment with no current plans for IP licensing, and the patents represent a significant part of their current value. If your company fits this model and you have an unencumbered portfolio with significant infringement/licensing potential, then you should consider IP debt.

"We formed IPNav Capital to offer our clients IP secured loans. For some companies, this will prove to be the best method to extract value from their IP and the best financial alternative," says Erich Spangenberg, CEO of IP Navigation Group and IPNav Capital. "It will be far less dilutive than traditional VC financing and far less restrictive than typical bank financing. In general, depending on the loan-to-value ratio, borrowers will be looking at high-yield bond type rates if they borrow at somewhere around the midpoint value between liquidation and enforcement value."

How do you define value?

In preparing for this article we interviewed

Figure 3. **An IP debt action plan**

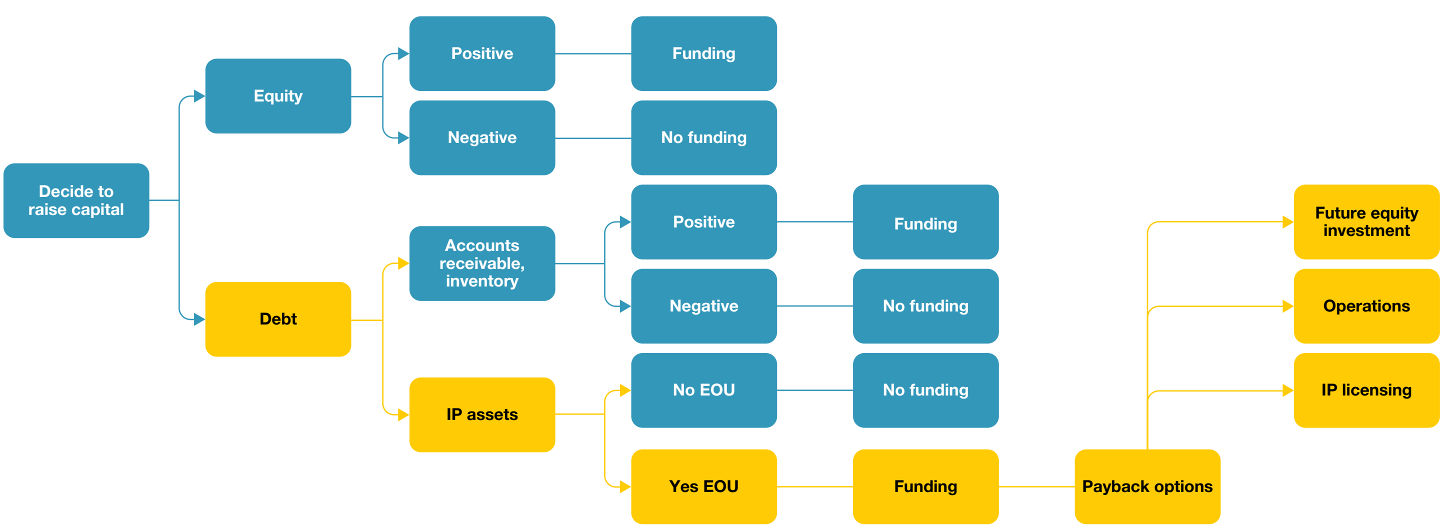

Figure 4. **Typical IP debt loan terms overview**

Term	24-48 months
Interest-only period	0-12 months
Interest rate	8%-15%
Facility and back-end fee	Applicable
Financial covenants	Combination of min and max
Warrant coverage	Yes

a half a dozen companies engaged in IP debt. What is clear is that they do not agree on the definition of 'IP value'. The companies interviewed fell into two broad camps on asset value: one is effectively the liquidation value of selling the IP assets today in the market (which can be characterised by Ocean Tomo LLC); the other is based on estimating the net proceeds from an enforcement campaign if the assets were asserted today (characterised by IPNav Capital).

Liquidation value

Two concepts define liquidation value. 'Fair market value' (FMV) is the price at which the intellectual property would change hands between a willing buyer and a willing seller when the former is under no compulsion to buy and the latter under no compulsion to sell, and both parties have reasonable knowledge of relevant facts. In addition, the hypothetical buyer and seller are assumed to be both willing and able to trade, and to be well informed about the property and the market for such property.

'Distressed FMV' is an estimate, expressed in terms of US dollars, that may be reasonably expected to be realised for the relevant intellectual property in a privately negotiated sale, properly advertised and professionally managed, by a seller obligated to sell over a limited period of time – usually within six to 12 months of the effective date of the appraisal report. Further, this definition assumes a scenario in which the company is in financial distress and hence the asset's value has been diminished. The distressed FMV is intended to reflect the realisable value of the subject asset in an orderly liquidation of the company's assets. This definition does not represent expectations of a bankruptcy auction.

Licensing value

In those rare cases where a company has a licensing programme, the IP lender's job is to estimate future licensing revenues. Based on its estimate of future cash flows, it decides whether there is sufficient cash flow to cover the debt and debt service.

In most cases the borrower has no IP licensing programme, so the lender estimates what an enforcement campaign would generate. The success of an enforcement campaign is driven by who is infringing and the size of the expected licensing revenues and settlements over a five-year period.

Comparing the two valuation approaches

The valuation difference between the two approaches (liquidation and licensing) can be a major differentiator when pursuing IP debt. Choosing to pursue IP debt with a lender that uses liquidation value may generate a much lower amount compared to a lender that begins the process with a valuation based on licensing revenues. Since liquidation generally yields a lower price compared to enforcement, the starting point for valuation is therefore much lower. That lower amount is then discounted to arrive at the amount available for lending.

The valuation differences often reflect the differences in the lineage of the companies involved in IP lending. Monetisation companies (eg, former brokers and auction houses) tend to view value on a liquidation model. Those in the enforcement business (primarily NPEs) tend to view value on the basis of what they could generate in licensing revenues. At a minimum, the two models reflect differences in the arbitrage between what someone would pay for an asset and how much they think they could generate, either in a subsequent sale or in licence revenue through enforcement over a longer period.

How to determine whether your company is a good candidate for IP debt

"It is always easier to get a corporate loan on inventory or accounts receivable than IP," says Friedman. "Why do an IP collateral debt deal? Either because the company's other assets are fully encumbered or because it is a new company with few tangible assets and significant intangible assets."

The key criteria for deciding to pursue IP debt are threefold: evidence of use, repayment capability and defence position.

Action plan

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When looking at debt secured by IP assets, the first steps are to:

- Determine your cash requirements.
- Rule out conventional means of raising cash because equity may be too negative or too expensive; or debt secured by receivables or inventories in the asset class may already be encumbered or insufficient to meet cash needs.

Debt secured by IP assets may be a viable strategy if conventional debt or equity alternatives are unavailable. If that is the case, determine that clear evidence of use exists. If none exists, IP debt is not an option. However, if it does:

- Collect evidence of use and generate claim charts; provide documentation of all IP encumbrances (eg, licences, liens), the last round of financing, cap table of company, warrants outstanding.
- Develop a valuation based on either asset sale or licensing models.
- Generate a financial plan to show sources and uses of capital, and means for paying back the loan via equity, revenues from operations or revenue from a future IP licensing programme.
- Obtain debt through an intermediary such as a patent broker or IP advisory firm. An intermediary will provide advice and assist in preparing evidence of use, market sizing and corporate financial information in negotiating IP debt deals.
- Present business opportunity, allow lenders to conduct due diligence and negotiate terms and amounts.

Evidence of use

Current evidence of use means current claim charts that map major companies' products to your patents. The engines of value and debtworthiness are tied to current market leader infringement and the ability to license or sell your IP portfolio for an amount that is significantly larger than the borrowed amount. If you have a portfolio that has no current evidence of use, then in all likelihood you cannot borrow against it. Without current evidence of use, neither of the two valuation models used for lending (liquidation or monetisation through enforcement) will generate much or any cash at the current time. Valuation for lending is not how much was spent on developing and prosecuting a patent portfolio. Sunk costs, book value or assigned R&D costs have no relationship to perceived value or value as collateral.

Repayment capability

If your company has rising revenues and is using IP debt to increase sales and therefore future revenues, you must be able to show how the debt will be repaid from operations. The plans for the debt must generate sufficient operating cash flow to pay back the debt and interest. "The question as a lender is always: if I loan you this money, how am I going to get paid back?" says Michael J Dansky, executive director of Capstone Advisory Group LLC, Intellectual Property Practice. "What activities are we tying the IP debt to that will generate cash flow and payment of interest and principal? Is it operations (business cash flow), licensing? IP debt has been tied in the past to royalty streams for companies that already have licensing up and running."

Defence position

Another factor to consider in deciding to pursue IP debt is how you will respond to enforcement action by another operating company. Asserting the patents being used as collateral for a loan puts the collateral at risk. The lender will want to participate in the defence strategy, as the likelihood of re-examination is high and could jeopardise the patents' value. One lender said that any action would have to be reviewed on a case-by-case basis, as it depends on the company and the situation. If the lender does not support a defensive use of the collateral, the borrower may need to repay the loan and then proceed with its response.

The role of intermediaries

Current IP market intermediaries, such as brokers and IP advisory firms, are primarily engaged in buying and selling patents. When asked how a company can raise capital with its IP assets, most intermediaries advise companies to sell the IP assets to operating companies and NPEs because there has been no other alterative for raising capital in under 12 months.

IP debt is a new and emerging option for intermediaries, as it enables a transaction to occur where one might not otherwise happen. If the choice is between not selling the assets or facilitating an IP debt transaction, the intermediary is incentivised to do a debt deal rather than no deal at all. Further, IP debt may emerge as a niche funding option for companies that are otherwise unable to raise funds in other arenas. Offering clients a chance to raise capital rather than sell assets may become a mainstream service offering of intermediaries.

Using a broker to raise cash from IP assets is an accepted industry practice. What brokers must now embrace is including the option of an IP debt instrument instead of an IP sale, so that companies can retain control of their assets and still raise cash. It provides an alternative or competing outcome to the current market opportunities of selling IP assets to operating companies or NPEs to raise cash.

Preparing for a debt placement requires the broker to assemble all of the same evidence of use and market information that is currently recommended for selling patents, plus financial information and management access to enable assessment of business risk. Leading brokerage firms will make this transition, and it is possible that some portfolios will be offered to the market strictly as debt deals, and not for sale, in the very near future.

A new alternative

Patents are inherently risky assets, as the market is relatively new and valuation is imprecise. Using patents as the primary collateral for a loan is higher risk for the lender and possibly more expensive than other forms of capital for the borrower. However, it may be a good option for companies that cannot raise additional equity or borrow against other assets.

Lending against those patents will enable selected NPEs or groups with NPE backgrounds to leverage their infrastructure and partner with corporate lenders to create new revenue streams. Of course, IP debt is a viable alternative for borrowers only when there is clear and documented evidence of use of the IP portfolio and a logical path to repaying the debt within the loan's period. IP debt is not a panacea, but it will emerge as an alternative to generate cash for companies meeting these criteria. *iam*

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