IP-backed securitisation: goldmine or hype?

Anyone familiar with the IP-value conference circuit will by now have heard about intellectual property-backed securitisation. Coming at a time when many companies are facing liquidity squeezes, attention has been focused on the previously untapped value residing in intangible assets and the ways in which these assets can be used to plug into readily available asset-backed debt funding. By ***Nigel Page***

According to its fans, IP-backed securitisation is poised to take off in a very big way. With 90% of worldwide corporate net worth now being attributed to intangibles and intellectual property (and the total asset value of patents worldwide estimated to be US$1 trillion), the verve with which industry proponents are seeking to market this apparent goldmine borders on the evangelical. The ongoing liquidity squeeze, increased openness to IP commercialisation, and availability of highly-specialised financial, legal and tax advisers in this field, have converged, they say, creating a unique nexus of opportunity.

Certainly, momentum is building and deals – many of them ground-breaking – are undeniably getting completed across a number of industry sectors. The dearth of liquidity has been a powerful marketing tool, with many companies (especially those in the mid-market) apparently eager to grasp the securitisation funding lifeline. Rather than swallowing the 22% to 30% rates of return demanded by mezzanine lenders, exorbitantly expensive equity capital, or combinations of the two, the mysteries of structured financing can look like an eminently viable alternative.

Understanding securitisation

By any measure, the asset-backed securitisation (ABS) market is huge. In its simplest form, asset securitisation means the conversion of assets or cashflow into marketable securities (typically rated) called asset-backed securities. These are sold to investors, and repaid from the cashflow derived from a pool of income-producing assets. And though the end result of securitisation is financing, it is not financing as such – the company securitising its assets is not borrowing money. Securitisation has a number of advantages for issuers. In particular, at the mid-market level, even unrated entities can issue highly-rated, investment grade securities that carry a lower rate of interest than conventional bank financing.

The structured market has evolved dramatically since the earliest securitisations of real estate assets in the US in the 1970s/1980s, as consumer finance companies began to securitise consumer credit to push up their debt ratings and minimise financing costs. From those beginnings, structured products have evolved from being just one more alternative funding source, to perform other roles including being a tool for risk, a source of liquidity, a diversified and tailored investment product and a strategic arbitrage platform. According to figures released by *Asset Securitization Report*, asset-backed commercial paper peaked at US$754bn in 2002, ending Q1 2003 at US$704bn.

IP-backed securitisation is a relatively recent phenomenon. The first deals sprang from the film studio sector in the early 1990s and were based around the future-flow structure already established in the wider ABS market. But widespread attention only began to focus on the potential for IP-backed deals with the so-called Bowie Bond deal in 1997. To date, the total market size remains small. In 1997 there were just US$380m in known IP-backed securitisation transactions. By 2000 that had grown to an estimated US$1.13bn and by the end of 2002 that figure was closer to US$15bn, once figures for whole-company deals were factored in.

David Edwards, vice president of securitisation marketing at Atradius (formerly catalogues tend to show less volatility as the film industry has followed the same pattern for many years where a few blockbusters (perhaps 5% of the total releases) finance the rest of the releases. "This all-or-nothing type of economics exhibits the same log normal distribution that call options and technology do - clustering around zero, vast majority of little value, and a small percentage with high payoff. The few hits pay for the many flops and the catalogues behave like a portfolio of assets whose diversification smooths the volatility of revenues," Edwards says.

Nick Goumas of Ambac Assurance (a provider of financial guarantees to these deals) agrees with Edwards that film financing deals are essentially extensions of future-flow transactions, demanding the same cashflow modelling. However, the greater focus on IP means focusing on more technical elements, and that means a higher standard of diligence is required. For this reason, he explains, these deals are expensive and hard to justify to issuers looking to raise much less than US$100m from the transaction. For Goumas, as for many others interviewed while researching this article, drug royalty deals represent a real source of potential. "There's definitely something happening there and these deals could begin to make sense, even to companies that already have access to capital but nevertheless want to realise value from their IP portfolios," Goumas says. However, he warns that technical issues remain - other patents may be needed before value can be realised, for example. "On top of that there are what we call cliff risks - notably whether a given drug causes side effects and has to be withdrawn from the marketplace, and whether a competing drug comes onto the market. And then there are unforeseeable legislative risks," Goumas explains. "While challenging, we have seen transactions in the space and there are those that have successful conclusions. On others, there may be some way to go yet; the probability of success is highly fact-specific," he adds.

Securitisation demystified

All ABS transactions follow a basic structure. The issuer transfers the assets to be securitised to a special purpose entity (SPE), usually a wholly-owned subsidiary of the issuing company. The SPE transfers these assets to a trust, which then issues securities backed by the assets. These securities are sold to investors either via a private placement, or an SEC-registered public offering. The asset owner (the issuing company) continues to service the assets, collecting payments from those obliged to make them and placing the funds in a segregated account in the trust's name. The trustee makes interest and principal payments to the bondholders from those funds.

Because the transaction means removing the securitised assets from their original owner, this isolates from the owner's business risk (bankruptcy, for example). This means that ABS securities can be rated investment grade by rating agencies, qualifying them for a much lower rate of interest than other debt, even where the original asset owner was unrated and therefore unable to access the public and private debt securities markets.

The costs of structuring an ABS deal, especially the first one undertaken by a company, are usually higher than arranging bank financing. But if the deal is large enough, or follow-on deals are envisaged, the cost difference is reduced. In any event, because of the lower interest rates on its securities, the ABS deal will generally be less costly overall.

ABS deals are comparatively straightforward where assets with fixed cashflows are concerned (eg, pools of mortgage or auto loans). However, where trademark and other IP assets are involved, licence royalties are often tied to the amount of products sold. Therefore IP income often fluctuates and it can be hard to predict with precision what the cashflow will be in two, five, or 10 years time. However, the rating agencies usually accept adequate historical experience (typically three to five years) with a particular company's portfolio as being sufficiently reliable data to project future performance. This means that ABS deals can be used to unlock value in IP assets that would otherwise remain untapped.

Most securitised assets pay off and disappear over time but most IP assets (especially trademarks and copyrights) have long lifespans and can even become more valuable over time. When an IP-backed ABS deal reaches maturity and the securities have been paid off, the assets can therefore be used in another ABS deal.

One point to stress where IP-backed deals are concerned is the matter of definition. Quite often, IP-backed securitisation deals get conflated with whole-business deals which, while prevalent in the European market, are problematic structures in the United States under the borrower-friendly US bankruptcy legislation. In Europe, and particularly the UK, whole-business deals (where the issuer grants security over his core assets, usually in the form of a fixed and floating charge) have flourished until quite recently, although the market has now started to cool off. In the US, however, where the concept of a floating charge over all assets does not exist, deal structures tend to be much more asset-specific and for the purposes of this article, attention is focused on deals where IP assets are the primary focus.

*With thanks to **Andrew Katz**, partner in the Los Angeles office of Mitchell Silberberg & Knupp, 'Financial alchemy turns intellectual property into cash: securitization of trademarks, copyrights and other intellectual property.'*

Gerling NCM, the credit insurance and trade receivables management company in which Deutsche Bank and Swiss Re are the primary shareholders) explains that the vast majority of issuance by dollar volume has occurred in the film industry, followed by music (although by transaction number there have been far more in the music industry). "Film catalogues represent large, predictable assets with clearly defined historical cashflows and relatively little variance," says Edwards. Similarly, he explains, future-flow transactions backed by film

Wall Street hangs back, until now

With a few exceptions, the predominantly mid-market focus of these deals to date has, until quite recently, placed them off-limits for many of the big Wall Street houses. Bear Stearns and Morgan Stanley have both bucked the trend (the former advising on one of the headline DreamWorks deals, as well as two sports facility financings, and the latter advising on the Arby's franchise fee-backed deal completed with Swiss Re New Markets and Ambac in November 2000), and CSFB and JP Morgan have also featured strongly in some of the more interesting headline deals (for instance, CSFB, led by Rob Horowitz, structured and underwrote this summer's Royalty Pharma Finance Trust deal).

There are also indications that other Bulge Bracket institutions are keen to get in on the act as antennae pick up the billion-dollar status of recent film receivables transactions. Certainly JP Morgan, FleetBoston and Bank of America have all been involved in these deals, and Merrill Lynch hit the trade headlines this summer with the news that it had hired Peter Hoffman (formerly with FleetBoston Financial Corp) to bolster its IP-backed securitisation capability.

Ira Wagner at Bear Stearns is a recognised authority on this sector and, for him, there is definitely opportunity in the market – although he remains concerned by the damaging effects of hype on issuer expectations. "We've looked at a number of deals, some in the entertainment area, and some in the pharma royalty area. In the latter area, we think that deals involving pools of royalties – rather than single companies – could be the way this develops. Certainly it is unlikely for the moment that the big drug companies would do one of these deals on a standalone basis, as it could be more expensive for them than raising their own debt – and for the smaller companies, it could still be hard to get a rating," he says.

Asked to highlight what he watches out for in a potential deal, Wagner points to long-term, contractually-obligated and relatively stable revenue streams. Dave Moran from Partner Re, the reinsurance group which is a risk taker in a number of transactions in this space including the Guess? deal handled by JP Morgan Securities earlier this year, shares this outlook. "We try to identify risks that we can understand and that usually means defining a finite set of risk drivers. We look for cashflows that are clearly attributable to the assets because this makes it easier for us to measure what can go wrong. We also look to have a general agreement of the economics and deal sizing from early on – which is critical as these deals take a long time to work out (between three to nine months on average)," he says. Concerns, Moran explains, stem from IP assets for which the cashflows lack a sufficient history, assets that are yet to produce a cashflow stream, and cashflows with high levels of volatility without a correspondingly appropriate level of subordination.

Wagner bemoans the unrealistic expectations that market hype has heaped on this sector. "We've pitched businesses where we say diverse assets could perhaps raise US$25m, only to have someone else pitch in saying the assets could raise US$35m. That kind of talk still derails too many deals," he says. Pete Walsh is co-head of origination and structuring in Harris Nesbitt Corp's US securitisation group; he agrees with Wagner about the hype. "We're seeing some activity but piracy has been a big issue, as well as the litigation risk surrounding patent enforcement and exploitation and excess hype in the music sector," he says. For Walsh, deals in the US$75m to $US100m range are principal targets. "Right now, we see real promise in international film assets and drug royalties, as well as, to a degree, some of the US universities, which sit on a lot of assets and could face some funding problems themselves," he says. Walsh, who has done deals in sports, music and movies to date, says that for his team there is no general rule for what makes these deals work. "They are all very asset and seller-specific. If the transaction is simply about collecting cheques from revenue streams, then there will be limited financial risk involved. But if there's an executory element, we take a much closer look," he explains. If brands are involved, in

Deal focus: film receivables – DreamWorks and Vivendi

One of the more interesting deals of 2002 was the DreamWorks deal, a film library/future film securitisation, rated by Moody's. The transaction was sponsored by DreamWorks LLC (DreamWorks) and backed by a portfolio of live action and animated films produced or co-produced by DreamWorks.

The US$1bn facility (structured by JP Morgan Securities and Fleet Securities Inc) was shadow-rated investment grade, had a financial guarantee policy issued by Ambac, and was syndicated to a group of asset-backed commercial paper conduits. It functions as a revolving facility through which the issuer, DW Funding LLC can borrow, pay down, and re-borrow amounts on a revolving basis. The 37 films included in the facility consisted of 2002 releases including *Minority Report* and *Road to Perdition*, as well as older releases including *American Beauty*, *Gladiator* and *A Beautiful Mind*. Unlike earlier DreamWorks securitisations, DW Funding was structured to remove film production risk, and to reduce the facility's exposure to film performance risk. This was accomplished by selling eligible films into the facility eight weeks after their domestic theatrical release.

Moody's also rated Vivendi Universal Entertainment's (VUE) securitisation facility, Universal Film Funding LLC in April this year (assigning it a Aaa rating), once again with a financial guarantee policy issued by Ambac. Like the DreamWorks deal, this facility is backed by a portfolio of films (this time produced or co-produced by Universal City Studios Productions, itself owned by Vivendi). The initial 121 films that are included in the facility consist of films released after 1995. The facility is intended to refinance a film library and finance, on an ongoing basis, anticipated gross receipts in distribution windows associated with newly-completed films produced, co-produced or acquired by Universal. Like the DW Funding deal, eligible films are sold into the facility eight weeks after their domestic theatrical release. By reviewing historical data and VUE's projection model, Moody's determined that at this point in a film's release, it is possible to work out with a relatively high level of certainty, the ultimate level of revenues it will generate through its complete first cycle. The amount VUE can withdraw from the facility for each film is based on a percentage of this ultimate revenue projection. The facility was syndicated to a group of asset-backed commercial paper conduits by JP Morgan Securities and Bank of America Securities.

Source *Moody's Investors Service* retail for example, he adds, his team takes a very close look to see if damage could be done to the value by anything causing brand deterioration.

Although Walsh looks forward to larger deals coming through from the drug royalty sector in particular, he does not expect any real specialisation in Wall Street just yet. “The economics of the financial market over the last couple of years have made people quite leery of specialisation,” he says.

Specialist business

Wall Street aside, in the main, the majority of the deals so far have been underwritten by three boutique finance firms: UCC Capital Corp (formerly CAK Universal Capital Corp), the Pullman Group (architects of the landmark Bowie Bond deal) and Royalty Pharma AG (which completed the first patent royalty securitisation with Yale University’s US$115m BioPharma Royalty Trust deal, founded on the patent and licensing agreement between the university and Bristol-Myers Squibb for the Zerit drug).

Robert D’Loren, president and CEO of UCC Capital, explains why he believes so much potential exists in IP-related deals. “Commercial banks are still lending based on an old-fashioned supply-chain model. Our view is that, in the next economy, those supply-chain models will not survive. The new model for the next economy is a ValueNet model where production will be outsourced to the lowest-cost common denominator,” he says. What that means, D’Loren explains, is that a company’s value revolves around its brand and its ability to market, merchandise and establish new production and distribution channels “and that’s what we are designed to finance,” he says.

UCC Capital has been a pioneer in this field. Early on it advised on whole-company securitisations for TVT Records and performing rights organisation SESAC, as well as putting together the Bill Blass bond issue, where US$25m was monetised by the royalty stream generated by the late designer’s label. The acquisition of that business was financed principally by the sale of US$25m in asset-backed securities with UCC Capital lending money to the new business owners, Blass’ largest licensee, Haresh Tharani and Blass’ CFO, Michael Groveman. Rated BBB+ by Fitch, the bonds are self-liquidating and due to be paid off in 2009.

Since then, UCC Capital has gone on to advise on a number of other IP-backed securitisations, including the US$30m Gloria Vanderbilt bond deal in 2001 (backed by the company’s earnings from trademarks and licensing agreements); the US$20m bond deal for Candies Inc completed in 2002 (rated Baa3 by Moody’s Investors Service); and the July 2003 deal for the Athlete’s Foot, with long-term fixed-rate bonds (rated B/aa3 by Moody’s) backed by franchise revenues and privately placed. UCC Capital also announced last year that, using capital from a General Electric unit, it hoped to make as much as US$500m in loans to companies willing to put their regular income from patents (or from the licensing of fashion logos) up as collateral – UCC Capital will then bundle those loans into bonds for sale on Wall Street. For D’Loren, the consolidation in investment banks and finance companies has created a gap in the market for an improved lending model which he hopes to exploit.

The line between securitisation and financing

Specialist niche IP finance firms currently crowd the IP monetisation space, some of them focused on securitisation, others on IP-collateralised loans, and it is little surprise that many companies find themselves unable to differentiate between each type of activity. As a matter of definition, securitisation is one route for IP monetisation, and using IP as collateral for loans is another.

Keith Bergelt is senior VP of intellectual property for the newly-launched niche firm IP Innovations Financial Services, which provides financial institutions with 100% financial guarantees for IP-backed loans (and has secured US$25M in financial capital support from Principal Financial Group to facilitate these transactions). He is convinced that the time is right for this activity, and that it helps fill a space for IP-monetisation alongside securitisation. “There is increasing socialisation around this area in organisations, with a palpable shift over the last eight years as CFOs, CTOs and heads of IP have actually come together to invest in and monetise IP. This is creating a link between R&D, IP and monetisation,” he says.

Bergelt, formerly general manager of strategic intellectual asset management and director of corporate strategy for Motorola, and more recently senior VP of strategy, business development and licensing for Cambridge Display Technology, argues that because each IP-backed loan comes with IPI’s 100% financial guarantee, all risk of default is essentially eliminated, so allowing lenders to leverage their existing infrastructure and increase earnings without taking on any economic risk. He estimates that a lender with a portfolio of 10,000 IP-centric clients (i.e., companies that maintain significant IP holdings) has the opportunity to book an additional US$10 billion in loans during the first year of IPI’s programme, generating over

US$500 million in fee and net interest income. "We're working on a number of deals right now with a broad range of companies holding significant patent portfolios. Larger companies from the electronics and telecommunications industry, in particular, are currently facing extreme debt servicing requirements, having misjudged recent economic cycles and reschedulings are hard, and expensive, to arrange," he says. As a result, Bergelt explains, these companies are looking for non-traditional forms of capital and welcome IPI's role in facilitating the emergence of IP as an effective form of collateral for new loans. "We're allowing these organisations to be more creative in leveraging the value they currently hold and, in the process, ushering in a new asset class in the form of IP," he concludes.

The Bowie Bond deal

Speak to most people about IP-backed securitisation and one of the first deals to get mentioned will be the 1997 Bowie Bond deal, through which David Bowie sold his music rights for US$55m to a group of bankers who issued bonds backed by Bowie's residuals. The bonds, rated A3 and yielding around 8%, were bought by Prudential and other insurance companies, and the deal was put together by David Pullman, a banker with his own niche firm in this field, the eponymous Pullman Group.

Pullman, who has had ongoing legal battles claiming his legal ownership of the deal structure, has since put together similar deals for other artists including Marvin Gaye, the Isley Brothers, James Brown and Motown. To widespread press interest, Moody's put the Bowie bonds under review this summer, prompted by the decline in retail sales across the music entertainment industry. Pullman, however, is quick to put this development into perspective, linking it to Moody's March 2003 downgrade of EMI Group plc, which provided a US$30m 15-year guarantee for the catalogue licence the Bowie deal was based upon. "The Bowie Bonds are on watch for a possible downgrade from their current A3 level, but a one-notch downgrade would still qualify the issue as investment grade. If, for whatever reason, EMI didn't pay, we could still go out and re-license the catalogue for another very significant upfront sum, and that doesn't even begin to take the publishing income into account," he says.

Contradicting some press reports that query whether subsequent music-related securitisations could also be affected by the slump in music sales, Pullman points out that file-sharing has not knocked the music industry back that much. "When we started doing these deals seven years ago, there was such a hot equity market that could access practically free equity. Now it's not so easy

A banker's perspective

Whole company securitisation provides the borrower/issuer with a new form of liquidity and an extremely efficient cost of capital. It is a multi-billion dollar lending market. It is the next economy corporate financing vehicle and it is a win-win for all parties involved.

There are many benefits for the issuer in this type of financing. These benefits include leverage, low cost of funds, fixed rate, long-term, less loan covenants and restrictions and non-recourse financing. For the investor, there exists a favourable balance between risk and reward in whole company, royalty and contractually-obligated income stream (COI) securitisations. As in any new lending market where liquidity is introduced where it did not exist before, and little competition exists from competing lending sources, underwriting and loan structures are uncompromised and margins are strong supporting this risk/reward relationship. Finally, at the macro level, most of the assets backing these transactions are not at the top of their value curve. In fact, many of them will realise significant revenue growth in the future, given changes in technology, operating business models and the effects of industry convergences.

A whole company securitisation (WCS) is a form of structured financing in which a line of business (which may be a substantial portion of the assets of a company) is sold by the company to one or more limited-purpose bankruptcy-remote vehicles, an affiliate of which issues securities backed by the assets. These transactions generally involve assets that are portable. Also, they isolate one or more of the company's predictable income streams. The structure mitigates certain risks typically associated with traditional corporate loan structures in cases where intellectual property, COI or other portable assets are being underwritten. In most cases, the WCS transaction structure separates production and/or operating risk from market risk. The goal from the lender's/investor's perspective is to underwrite the market risk and mitigate or eliminate production and bankruptcy risk through a corporate bifurcation process.

There are many benefits for the borrower/issuer in these transactions, the two most significant of which are optimal leverage and that these transactions enable it to issue debt at ratings that are up to five notches above the company's underlying rating, thereby significantly reducing its cost of capital.

The WCS structured financing provides for enhanced control over the underwritten assets in a distressed situation and incorporates the following underlying key features:

- Mitigates bankruptcy risk – incorporates transfer of assets through true sale to bankruptcy-remote special purpose entity (SPE).
- Provides for trustee directed cash accounts.
- Provides self enhancements – liquidity reserves, etc.
- Provides for replacement of management, if needed – deal triggers tied to debt service

and we will see the major corporates that hold these [IP] assets becoming more flexible. The need for innovative financings will increase. Intellectual property is continuing to grow [in importance]. Human groups will continue to innovate," he says.

Entertainment industry analysts seem to be on Pullman's side. The June 2003 issue of *Investment Dealers Digest* reported that the general view is that there is far less chance of the bondholders getting wiped out in the event of a default on the Bowie bonds than there is on a standard corporate asset-backed transaction. The deal was structured so that they would be able to sell the underlying assets if the bonds defaulted and, because most major music catalogues now trade at around 20 times net publisher share, the Bowie bondholders have little to worry about.

The fact that this asset class has ongoing potential was underlined in 2001 with the US$60m transaction backed by music publishing royalties generated by the catalogue of UK company Chrysalis (issued as Music Finance Corp). Rated investment grade by Moody's, the deal had a number of stand-out characteristics: it was the largest music royalty deal completed to date, including over 35,000 copyrights from hundreds of songwriters in various jurisdictions. The deal was also the first to securitise a music publisher's catalogue, rather than an individual artist.

Still room for scepticism, however….

There's no denying the dealflow passing through some of these specialist houses, or the enthusiasm with which Robert D'Loren, David Pullman and others put their case. But for some industry participants, the prospect of a wide-open, fast-growing IP-backed securitisation market is still some way off. Lionel Leventhal, principal at Paul Capital Partners (which acquires private equity and healthcare royalty assets through the secondary markets) remains sceptical. "There's a very large gap between theory and practice here, in both the pharma and the high-tech sectors. There have been many presentations at conferences put on by organisations like the Licensing Executives Society on IP securitisation that may have raised a lot of false hopes about these deals being very easy. Only large diversified portfolios of intellectual property that are currently producing large amounts of cash flow that are not volatile are easily securitisable," he says.

Leventhal believes that, more often than not, people mean monetisation when they say securitisation. Monetisation of intellectual property, he explains, means selling or pledging rights in return for cash payments now and in the future. Securitisation is a subset of monetisation and only one particular flavour of monetisation. "There are many more

coverage ratio, trigger usually set at levels of coverage well in advance of an actual monetary default.

- Establishes back-up operating manager at closing.
- Inherently provides multiple exits for collateral.
- Isolates production and/or operations risk through bifurcation of company.
- Provides flexibility for borrower/issuer upon dilution of cashflows.

To understand the bifurcated company structure that is generally utilised in these transactions, one needs to understand the differences in supply chain v ValueNet business models.

In a supply chain operating model, a company focuses its resources on production. This model ties up a great deal of resources in working capital and represents an inflexible operating structure that leaves a company unable to react to market changes and other external forces. In most cases, the company follows a push strategy in selling its products into a market. A primary flaw in this strategy is that the consumer may not want or need the products. In today's market, the consumer has much more power over the purchasing process. This enhanced power has been enabled by the internet. We believe that while this business model has worked in the past, it is becoming difficult for companies to compete this way in an ever more competitive and connected marketplace. Many of these risks may be mitigated or totally eliminated in a ValueNet business model.

In the ValueNet model, the company remains flexible by forming a strategic alliance with its distribution channel and third-party producers of products. In this model, the distribution channel (eg, retailers) focus on customer acquisition; manufacturers and wholesalers focus on merchandising and delivery; and the IP owner focuses on brand strategy, marketing and promotion, product designs, quality standards and customer trends, and outsources production on a free-agency basis to the most efficient production source. Together, the group makes a value net that is efficient and flexible. It follows a pull sales strategy and delivers products that its customers need and want based upon their actual input. In certain cases where COI is the asset providing the collateral for the securitisation, the bifurcated company structure is not utilised. In these transactions the structure is similar in respects to a securitisation of financial instruments. This is the case because COI, like financial instruments, is an obligation to pay a certain sum on a certain date.

***Robert D'Loren**, chairman & CEO, UCC Capital Corporation* alternatives available for companies and institutions owning intellectual property that can effectively monetise intellectual property, including sales of royalty interests in IP, or licences of IP with large up front cash payments and other future milestone payments. There's a lot of confusion in the market – and this holds back progress," he says.

While there is undeniably great potential in this field, Leventhal explains, the market is still evolving slowly and it will be several years before it has developed to keep up with companies' ambitions in this area. Put bluntly, he says, most companies don't yet have broad enough IP portfolios that are cash flow producing to put these deals together.

Leventhal goes on to highlight one of the principal issues holding back wider acceptance of these deal structures in the market. "If I were the CFO of a big pharma company, then I'd be looking at a number of different ways of financing my business through debt and equity. I can raise debt in many different ways, just one of which is to decide to isolate revenues from the portfolio of my products through a securitisation. The question is, of course, to the extent that I can already access the commercial paper or MTN markets, does IP securitisation really represent a cheaper cost of capital to those larger pharma companies that have the requisite deep cash flow producing IP portfolios?" he says.

These views are echoed by others in the business. Richard Rudder, a partner at law firm Baker & McKenzie with a long track record in ABS deals (he advised David Bowie on the landmark 1997 deal), looks forward to the day when the market really starts to open up, but until then he will remain cautious. "Remember that this is a new business and very few deals are actually getting completed. It's still quite unique. We don't yet have a concerted push by the big investment banks going out to their clients and explaining how they can put these deals together. This means it is confined to a few specialist firms. Moreover, these are, almost exclusively, private deals and that means that the whole asset class does not tend to receive much publicity," he says.

Rudder is, however, hopeful that following the Bill Blass deal (where a securitisation structure helped fund the acquisition costs), potential does exist for follow-on transactions. "I've been trying to raise awareness of this amongst M&A clients. Basically an acquirer sees IP in the target that could be a source of value and there are different ways of reaching that asset," he explains. If it's a friendly deal, Rudder continues, then it should be quite straightforward to gain access to it. If it's a hostile deal, then the acquirer may need to raise short-term interim finance to do the deal, before paying it off with longer-term, lower-cost securitisation finance. "We're working on a deal using this technique right now, although it's fair to say that M&A advisers still don't focus on this technique as a matter of course," he says.

Hurdles in the way of progress

There is every indication that, over time, IP-backed deals will gain wider acceptance. For the moment, however, a number of hurdles will continue to hold back progress. As already discussed, some of these are cultural – many companies are still unaware of the potential rewards contained in this funding route. Others are prosaic demand/supply facts of life, explains Malcolm Dorris, partner with law firm Dechert LLP. "So far, there have been fewer deals than originally anticipated. One key reason is scale – most securitisation deals are US$100m-plus, but where IP-backed deals are concerned, few companies own IP to that value, nor need that amount of funding," he says. Jay Eisbruck of Moody's Investor Services puts it another way. "The level of debt that the asset can support dictates the type of participant we're seeing," he explains.

Another problem standing in the way of wider acceptance of these deals is their unique risk profile. Winston Chang is a director in Structured Finance's New Assets Group at Standard & Poor's. He explains that in many cases there will be various types of operational risk inherent to either the issuer or other counterparties (for example a marketer or distributor of drugs in a pharmaceutical deal) that do not exist in more plain vanilla securitisations. "This raises some challenges for investors. Bankruptcy remoteness is one – if you're trying to isolate IP assets, it's much harder than with a traditional loan portfolio deal and it is essential to make sure that the legal risks are properly identified," he says. Also, because these deals are usually based on cashflow projections they have the potential to far outperform, or under-perform expectations. "Of course, IP-backed securitisations are marketed at the usual ABS crowd, and a growing number of investors have become more familiar with some of the more esoteric deals. But that does not undermine our number one priority – risk identification and mitigation," Chang explains.

Chang goes on to identify another important consideration – whether IP-backed securities can be rated above their issuer's rating. "In the US, if you think about a sub-prime mortgage company, you can get a low-grade company issuing triple-A paper. But in the IP field, you're usually not going to get that," he says. Instead, there will often be a soft-linking to the rating of

Securitisation of patent drug royalty streams

Securitisations related to various forms of intellectual property have grown tremendously over the past several years. In particular, music royalties, film rights and, more recently, patent drug royalties have all been securitised. Indeed, given the size and the growth-potential of the pharmaceutical industry and the significant financing and capital needs of the players involved, securitisation is increasingly being considered as a viable financing source for this industry. There are, however, a number of unique legal challenges about which market participants and their legal advisors should be aware when undertaking a patent drug royalty stream securitisation. The legal issues are centred around two general areas. First, what happens if a party involved becomes the subject of bankruptcy proceedings? Secondly, issues surrounding the assets themselves.

As in any securitisation, the legal advisors spend a significant amount of effort ensuring that the cashflow from the assets will reach the lender and/or investors notwithstanding a bankruptcy of the effective borrower. This is generally accomplished by selling the assets to a special purpose bankruptcy-remote entity (SPE). In a prescription drug royalty securitisation, the borrower is entitled to receive a stream of payments from one or more parties that have entered into contractual relationships with the borrower. Unlike a standard securitisation, there is no obligation for any person to make a payment to the borrower unless a product is successfully marketed and sold. If the borrower owns the patents associated with the product and has entered into a licensing agreement with a manufacturer, problems in cashflow can develop if the manufacturer becomes insolvent. In the United States, a licence agreement is generally viewed as an executory contract which could be accepted, assigned or rejected by the licensee in its bankruptcy. If the licence arrangement is profitable, the licensee may accept the contract in its bankruptcy proceeding (ie, it can continue to manufacture and sell the product). If not, it may opt to reject the contact, in which event the borrower/SPE could try to re-license the drug.

In some cases, the borrower may not have direct rights in the patent or licence. It may simply have entered into a contractual relationship with another party which entitles it to receive payments from time to time based on sales. If the other party becomes the subject of a bankruptcy proceeding, the borrower will be treated as an unsecured creditor and the payments will probably stop. The legal advisors must understand the contractual relationships between the borrower and the patent holder, as well as the licensee and any sub-licensee, to fully understand the ramifications of an insolvency proceeding for any party associated with a prescription drug.

Perhaps one of the most important legal challenges associated with a royalty stream securitisation is the complex due diligence process. The diligence considerations related to a patent licensing arrangement are much more comprehensive than the diligence process undertaken in a more standard securitisation and it is extremely important that lenders and their counsel appreciate this complexity, and that borrowers are prepared to assume the cost of this comprehensive review.

As an initial matter, the lender will need to review the underlying licensing agreement setting forth the relationship between the patent holder and the manufacturer/marketer which pays royalties for the use of the patented technology. It is important that the parties gain an understanding of how the royalty stream actually works and pinpoint any provisions in the licensing arrangements which could interrupt that royalty stream. For example, questions the parties should consider include:

- What patents are actually involved in the transaction?
- Who is responsible for maintaining these patents?
- Does this party have the resources to adequately perform such maintenance?
- Does the licence agreement cover all of the patents that are being pledged as collateral?
- Do the underlying licence agreements account for related technology developed subsequent to the execution date of the licence agreement, or employ safeguards to capture new technological developments?
- Do the underlying licence agreements contain any milestone payments and other contingent payments that would require the patent holder to make a lump sum payment to the manufacturer or marketer?

In addition to reviewing the licensing arrangement to ensure that the payment stream will not be subject to any interruptions, a lender may also choose to employ patent counsel to review the nature of the patents involved. Ensuring that there are not any underlying problems with the patent is necessary to ensure that the royalty payment stream will not be interrupted by, for example, patent infringement litigation. This lengthy (and potentially costly) assessment will generally include:

- A review of the chain of title related to the patent
- A search for any post-issuance patent office activity that may negatively influence the scope of the patent claims at issue
- A search of the public databases for any patent infringement litigation involving any of the patents in the underlying licence
- A validity assessment of the claims in the subject patents
- A right-to-use analysis to assess whether the licensee will be free to practise the royalty generating commercial activities without infringing the patent rights of another.

Depending on the size and complexity of the transaction, this review can range from very basic to extremely in-depth. If the deal is sufficiently large, the lender may opt to review the underlying patents in depth and, in the process, also asses the economic viability of the patent on a going-forward basis. The lender will want to consider how easily a competitor can design around the patent claims, thus appropriating the technology used in the specification without actually infringing the patent claims, as well as whether the patent is at risk of technological obsolescence and, if so, whether there is any way of minimising the negative effects associated with such obsolescence.

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the originator or other counterparties from an operational or counterparty basis (in the Royalty Pharma deal, Chang explains, the risk is not so much that the originator goes away but the drug companies do not pay. The important point being that if the originator files bankruptcy there are a number of parties, including the trustee, that could step in and collect the royalty payments). “This differentiates these deals from the more traditional ones where assets stand by themselves. With IP deals there is still a big question mark over what happens if the originator goes bankrupt,” Chang says.

At a recent conference Chang recounts he heard someone say that there is definitely growth in the area but that it depends how you measure it. He agrees but with some reservations. “There does seem to be a lot of interest amongst larger institutions in this field but the challenges remain economics and certainty of execution. And remember that these deals are going to be unique: no two pharmaceutical deals are likely to be the same. That means that they will continue to be expensive and time-consuming to put together,” he says.

In other words, the uniqueness of these deals means that however many lawyers, bankers, monolines and rating agencies get involved, commoditisation remains out of the question. The next deal will always be a case of reinventing the wheel.

Looking ahead

As with any new asset class, problems abound. However, it pays to put this into perspective: 20 years ago, the ABS market was still in its infancy, today it is worth US$750bn-plus. “Since the Bill Blass deal, there’s no doubt that this technique has secured more publicity. My sense is that we’re seeing a bit more activity now – there’s more airflow around these transactions and the pace is quickening. I handled the first-ever commercial mortgage deal (in 1981), and it took another 10 years for that market to get firmly established,” says Richard Rudder.

Drug royalty-related deals are getting more publicity and, as most industry participants agree, this sector should represent a real source of potential. Certainly, the US$225m patent royalty securitisation from Royalty Pharma Finance Trust which closed this summer has showed the pharma industry that substantial deals of this type are possible. This was only the second-ever such transaction after the US$60m BioPharma Royalty Trust deal launched in 2000, and underwritten by WestLB, only to enter into early amortisation this year after patent holder Bristol-Myers Squibb sold off its inventory of HIV drug Zerig at a discount in late 2001. The Royalty Pharma Finance Trust deal, which was rated triple-A by both Moody’s and Standard & Poor’s, needed to allay market concerns following BioPharma’s amortisation. Thanks in part to the MBIA credit wrap and to the revolving pool of 13 different patent royalty payments (allowing for the supply/demand imbalances associated with a single royalty’s cashflows to be replaced during the three-year revolving period) the deal sold well.

And entertainment-linked IP deals also have a rosy future, providing entertainment industry professionals with all too rare access to the capital markets. In *There’s No Business Like Show Business*, a 1999 special report on music-royalty and IP-backed transactions, Moody’s noted: “The transactions done to date ... represent only a thin slice of the potential music royalty securitisation market. Although all of these deals have been done in the private placement market, it is possible that they could eventually enter the public market as well, as the deals become larger and a wider array of investors become more comfortable with these asset classes.” And this viewpoint still makes sense.

Film receivables too have shown their mettle (with the DreamWorks and Vivendi deals), and the slew of fashion, retail and franchising sector deals also bode well, providing the industry with much-needed templates for future structures, while acquainting an ever-broadening investor base with what the asset class has to offer.

Jordan Yarett, a partner at Paul Weiss Rifkind Wharton & Garrison LLP, advised on the Arby’s franchise royalty securitisation deal and has, since then, advised on a series of deals involving hotel and restaurant chain franchises, amongst others. He for one has no doubt that real growth prospects exist. “In the last six months we’ve been approached by two other restaurant chains and we’re working on another deal. It’s fair to say that a lot of industries have real potential for these deals via their existing franchise arrangements,” he claims.

Hype thus far has done the industry few favours. IP-backed securitisations can, and do, present unique challenges and overcoming these will take time. That said, there is no denying the gathering momentum across various industries for new forms of IP monetisation - whether securitisation or new forms of collateralisation. For the moment, we should expect to see a continuing blurring of boundaries between IP-backed securitisations and IP monetisation, as industry participants, from Wall Street bankers to specialist IP finance houses, jostle for position in the market. ■

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