Monetising intangibles – the way forward

Intellectual property monetisation strategies need greater focus. Until this can be achieved, the global investment community will remain wary of IP as an asset class. A recent high-level symposium held in upstate New York marked a commitment to drive this issue into the mainstream

Corporate intangibles, including intellectual property, are valuable assets representing an increasing proportion of the global market capitalisation. The studies that point to intangibles representing up to 80% of the value of various stock markets are well known. Like any other corporate asset, they are exposed to the risk of impairment. Unlike most other tangible corporate assets, however, they are rarely covered by insurances.

In early October, in cooperation with *IAM* magazine's Finance Panel, the Intellectual Asset Finance Society (www.iafinance.org) held its first bespoke conference to explore solutions for identifying, controlling, mitigating and transferring intellectual asset risks. Based on the premise that convergence between the insurance and capital markets is paving the way for a new type of financial instrument (intellectual asset risk-linked securities), delegates at this event set about identifying the scale of the opportunity confronting IP owners and investors alike.

Held at Savannah Dhu, the home of Destiny USA founder and chairman, Robert Congel, in New York State's Finger Lake district, the two-day event brought together attendees representing expertise in corporate governance, trademark law, patent law, finance and insurance to participate in an intensive programme of breakout and plenary sessions.

Covering a number of key issues – brand, reputational and trademark risk; technology, know-how and patent risk; risk portfolio strategies; moral hazards and mitigation; indexing rates of loss; and creating a secondary market – the intent of these sessions was to get to the heart of investor concerns. What risks do these assets represent? How can these risks be controlled? And, crucially, how can these risks be transferred?

While there has been no shortage of debate around such issues, there was a strong consensus among all delegates at the event that talk alone will do little to help unlock the value of these assets. Action is needed.

Nir Kossovsky, IAFS executive secretary and CEO of TOPCAP, contextualised the debate by drawing attention to the development of risked-link securities (CAT bonds) in the 1990s. These bonds (which now have an annual volume of US$2 billion) are the result of securitising the risk of catastrophic property and casualty damage. Investors holding these bonds receive good returns when losses are within a "typical range". However, if losses are severe or catastrophic, the bonds may pay nothing. Generally falling into the non-investment grade category, they are becoming of particular interest to hedge funds.

The broader financial community is also starting to show interest. However, growth in this market is currently being held back by the limited number of sponsors. Only a few companies outside the insurance and reinsurance sectors have sponsored these securities to date. This is partly because companies prefer to delegate risk transfer to insurance brokers and partly because few companies face sufficient risk to underpin CAT bond issuance.

Here, Kossovsky explained, is the source of the opportunity. Capital markets are increasingly comfortable with risk securitisations and there is growing momentum behind risk transference. Meanwhile, sponsor attitudes to CAT bonds highlight the fact that the spectrum of risk needs to be broadened. Intellectual asset-related risk could play a key role in broadening that spectrum – provided that this new class of security can be structured and sold.

Introducing the symposium, and demonstrating that the measurement and quantification of risk is achievable, the Milken Institute's Joel Kurtzman highlighted the ongoing work being done by the Institute on its Opacity Index (originally launched as a joint effort with PricewaterhouseCoopers in 2000). Developed to promote understanding of the real risks faced by businesses investing abroad, the index sets about measuring the high-frequency, low-impact risks that threaten globalisation – the so-called opacity risks.

Having developed metrics to measure around 70 variables, the Index spans a total 48 countries, providing a risk barometer that takes into account corruption; the legal system; economic policy; accounting and corporate governance standards; and business and financial regulation (collectively referred to as "CLEAR"). China, India and

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Russia have high opacity scores – Finland, Denmark, the UK and Hong Kong region have low scores.

As he pointed out, if companies are to take advantage of global markets, they need to understand their risks (including their IP risks) – as well as identifying effective ways for transferring these risks. Risk-linked securities provide an ideal means for achieving this.

In the breakout sessions that followed, delegates set about clarifying key action points. With this in mind, Fish & Richardson's Jorge Torres mapped out the three main types of patent risk – so-called black box risks (risks attaching to adjudication in front of unpredictable institutions); management risks (is your management competent to deal with patent issues?); and reputational risk (public opinion shifting to question the way in which law may favour the patent holder).

Delegates agreed that, provided all the variables around these risks could be accurately quantified, it should prove possible to transfer them to the capital markets. Drawing parallels with the way in which the mortgage asset-backed securitisation market has grown up, delegates agreed that an effective market for intellectual asset risk-linked securities would only become established if these risks could be pooled (to provide investors with adequate diversification). A robust intermediary – a broker – would also be essential, providing a link between IP-owning companies and the capital markets.

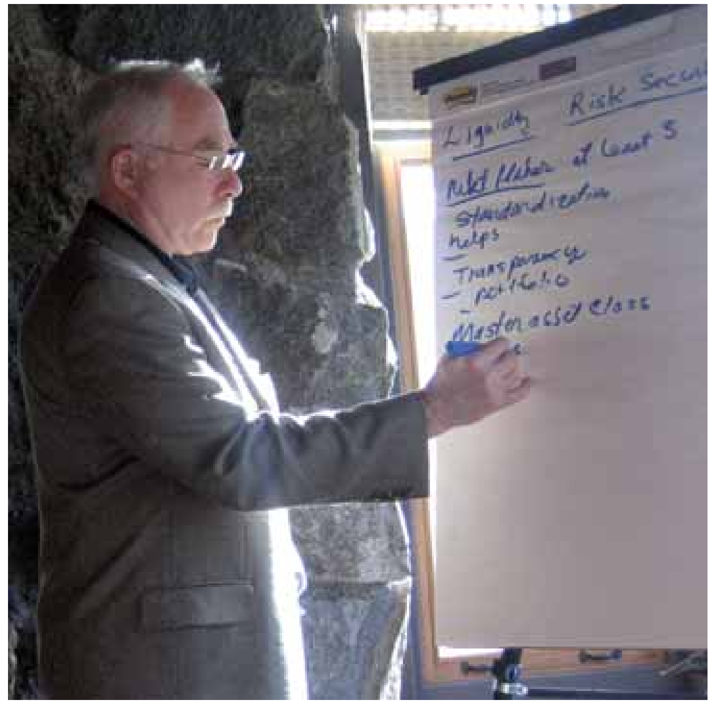
As the breakouts and plenaries continued, the scale of the opportunity became clearer. Delegates realised that, with the right educational framework in place, best practice could be developed. In particular, they agreed, the promulgation of international asset management standards would play a vital part in this process.

As Alfred Fasola of Johnson & Higgins put it: "Post Sarbanes-Oxley, directors have to manage enterprise value, risk and assets. And yet the indications are that less than 10% of directors know how to manage their IP/intangibles. This issue is still getting delegated to the general counsel." Calling for standards to be introduced, he continued: "We need to identify best practice for managing IP. There's a massive disconnect between what's happening and what we should be doing. There's a huge area of opportunity."

The key priorities must therefore be objective and consistent valuation metrics; best practice/governance; and education/lobbying. By teaming up with one of the established standards setters (the Financial Accounting Standards Board, for example), the IAFS could, delegates agreed, play a major role in kick-starting this process.

One of the major disincentives for investors is uncertainty. They need to know what IP value means and who determines it. They also need to know what happens when things go wrong – how can they exit their investments? Where is the liquidity that will enable them to do so? Just as in any other capital market, investors need reassurance that there are a number of market makers, willing and able to buy back these securities if necessary. Given the public policy issues – especially the potential for providing a huge boost to the funding of innovation – is there scope for a government-backed secondary market in intellectual asset risk-linked securities, for instance?

This was an inaugural meeting. And clearly, there is a long way to go before these big ideas begin to bed down into hard-nosed financial and commercial reality. However, there was a palpable sense of excitement. By adopting a standards-based approach and applying sound financial principles, the opportunity is evidently there to create a new class of intellectual risk-linked security. And if this new financial instrument can be created, it will have the potential to free up an enormous amount of capital.



Joel Kurtzman, *The Milken Institute*
Understanding business risk

Finance experts focus on IP

Delegates at the first IAFS symposium on intellectual asset risk-linked securities, held in cooperation with *IAM* magazine, included:

Jay Eisbruck, Moody's Investors Service
Jennifer Hanf, Deutsche Bank
Darren Cohen, Reed Smith
John Kwon, Deloitte
Jorge Torres, Fish & Richardson
Alex Krutov, Navigation Advisors
Karl Wilhelm, ipIQ
Michael Granito, Federated Investors
Kimberley Cauthorn, Kroll
John Brosnan, Aon Financial Services Group
Alfred Fasola, Johnson & Higgins Private Equity Solutions
Marc Lucier, Intangible Edge
Joel Kurtzman, Milken Institute
Richard Petrafesa, Destiny USA
Nir Kossovsky, IAFS and TOPCAP
Nigel Page, *IAM* magazine