# IP collateralisation in perspective

Securitisation may not be the best way for a company to raise capital using its IP. Instead, many businesses may find that the ideal option is to collateralise the rights they own

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Over the last 15 or so years there has been a palpable shift towards more creativity in the monetisation of intellectual property. From simply utilising patents as defensive dry powder in actions against aggressors in patent assertions and follow-on infringement actions to strategic licensing to securitisations and collateralisations, the landscape is replete with examples where thoughtful approaches have been adopted to leverage effectively the asset value inherent in patents, trademarks and copyrights.

While the foregoing trend by no means has proliferated to the point where individuals holding titles such as IP director, chief financial officer (CFO) and chief technology officer (CTO) are routinely working together to ensure the effective monetisation of IP in companies, a common monetisation lexicon is starting to develop across the disciplines of finance, technology and intellectual property law. The successes at IBM, Lucent, Dow, Texas Instruments, Motorola and others in developing and installing a generative capacity to characterise, categorise and monetise patents are providing a template for others to follow.

It is important to note, however, that it is not at these large corporations with their extensive patent estates and large IP departments that we see the most creative monetisation approaches being employed. Instead, it is at entities like Royalty Pharma, ATD Corporation, BCBG Max Azria, and Cambridge Display Technology where new solutions are being adopted. As is often the case, innovative approaches and products emerge from the edge (ie, from companies that face challenges to growth and are driven by circumstance) where need and creativity meet to deliver opportunity.

Due to the fact that most small to mid-size companies cannot avail themselves of the vast resources of the IBMs and Motorolas of this world to meet the challenges of IP monetisation, it will be in this realm of the creative edge of IP monetisation (ie, at small to mid-size companies) that the balance of this article will focus. For it is in this creative edge that the bulk of small to mid-cap companies are required to delve in order to harvest effectively their oft-times disproportionately large investments in intellectual property and create revenue or debt capacity to supply the capital needed to fuel future growth.

As we increasingly shift to a service economy and one driven by intangible assets, the mismatch between traditional lending and the preponderance of assets of companies found in post-industrial economies will increase demand for alternative lending vehicles.

Since much of the intangible asset value of a company comprises intellectual property, IP collateralisation and other creative approaches are essential in an environment where traditional asset based lenders will not accept the largest component of value in new economy companies – intellectual property – as a viable source of collateral.

## The collateralisation option

Given options such as dilutive venture capital or high cost mezzanine and second lien debt, the large pool of IP-rich small to mid-cap companies are seeking alternatives to access growth capital. As such, the first and best path to capital is to look within to the embedded intangible assets of the firm – its codified and non-codified intellectual property – as the sources of that capital. The new and creative approach outlined below – IP collateralisation – will provide an important tool to unlock the IP-asset value of such companies and ensure greater autonomy and independence and a path to growth.

IP collateralisation is essentially the use of IP as collateral in a traditional asset-based loan where a lender extends credit to a company based on an assessment of disposal value of the IP that is taken as collateral in the event the borrower defaults. For example, Supported by Principal Financial Group, IPI's credit support partner, IPI is able to provide any lender with a full guarantee to cover an IP tranche of a loan facility and thereby collateralise a loan based exclusively on IP in the form of patents, trademarks or copyrights. IPI may also fund IP-collateralised loans directly and in partnership with the company's partners at various financial institutions. Such collateralisation transactions typically carry a three year tenor and a conservative amortisation schedule. Table 2 illustrates the positioning of IP collateralisations in the context of the broader asset based lending market.

While the loan to value ratio or advance rate for IP is quite conservative relative to more traditional asset classes such as accounts receivable, inventory and property, plant and equipment, the advance rate is nonetheless consistent with the inherent risk in taking IP as collateral.

Several case studies where IP collateralisation has been successfully utilised to provide access to growth capital include: ATD Corporation, Cambridge Display Technology, Wise Foods and BCBG Max Azria.

## ATD Corporation

A maker of thermal and acoustic barrier technology for the automotive and white goods industries, ATD Corporation holds several of the core patents that support the use of single and multi-layered structures comprising aluminium, stainless steel and proprietary materials for these applications. As both the automotive and white goods markets are extremely price competitive, ATD has faced challenges to growth occasioned by limited access to capital. While remaining steadfast in its commitment to a mounting annual spend on a patent estate that is disproportionately large relative to its annual revenue, ATD entered 2004 at a crossroads and with a clear-cut mission to leverage its patents beyond its successful but modest licensing programme and grow shareholder value. As the number two or three supplier in the markets in which it competes, ATD's strategy involved expanding market share and more effectively utilising its patents to limit infringement by its competitors.

With this as the backdrop, ATD explored a number of different options. Specifically, ATD investigated securitisation and a number of other emerging vehicles beyond licensing to extract value from its IP. The prospect of securitisation's somewhat complicated legal structure in which ownership of its most valuable asset – its patents – would be transferred to a special purpose entity was of little appeal. ATD then happened upon an emerging trend in IP monetisation – collateralisation – and elected to pursue this option.

Since asset based lenders do not generally recognise IP as an effective form of collateral, ATD engaged a credit enhancement firm and originator of IP collateralisation transactions, to extend the lender a credit enhancement that essentially provided a dollar for dollar guarantee of the loan. The credit enhancement facility enabled ATD's patents to serve as an effective form of collateral to support a multimillion dollar loan from ATD's lender of choice, GMAC. Under this approach, ATD leveraged its considerable patent estate to generate additional working capital to expand its prototyping capability, product offering and marketing effort in its target markets. ATD did so without having to resort to far more costly options, such as raising additional equity or suffering the loss of management autonomy and control that is increasingly associated with high cost mezzanine capital and second lien loans.

## Cambridge Display Technology Ltd

The holder of the fundamental patents supporting next generation flat panel display technology for everything from mobile phones and laptop computers to widescreen televisions and electronic billboards, Cambridge Display Technology Ltd (CDT)

Table 1: **Market capitalisation: tangible versus intangible assets**

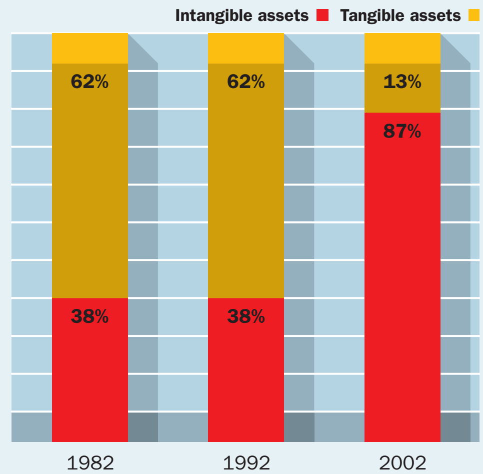


Table 2: **The asset based lending risk continuum and collateral advantage rates**

| Asset class | Intellectual property | Property plant & equipment | Inventory | Accounts receivable |
|---|---|---|---|---|
| Loan to value (LTV) | 10%-40%* | 50% | 65%-75% | 80%-85% |

*In securitisations where IP note is backed by well-established cash flows, LTV may be >60%.

entered 2004 continuing its efforts to spur the commercial introduction of its revolutionary polymer-based organic light emitting diode (PLED) technology. Having taken great pains to build an effective ecosystem of customers, suppliers and partners to support its commercialisation goal, CDT needed additional working capital. Although held in majority share since 1999 by Kelso and Hillman Capital, two New York-based private equity firms, and supported by strategic investment from the likes of DuPont and Sumitomo Chemical, CDT's management set its cap on being self sustaining from 2004 onwards.

As a licensing company, CDT understood that the lion's share of its revenue would come from royalty revenue once the likes of DuPont, Siemens/Osram, Philips, Seiko-Epson and other of its licensees entered commercial production of PLEDs – expected to begin in mid-2005. In an effort to maintain its own research and development, process refinement and commercial collaboration with prospective licensees in advance of the realisation of significant royalty revenue, the collateralisation solution offered great appeal to CDT's management and ownership as an alternative to bringing in additional investment and the attendant dilution associated therewith.

On the strength of its patent portfolio, extensive licensing history, unprecedented up front licensing fees (considering that PLED is still essentially a pre-commercial technology), size and growth trajectory of the market for the products supported by the PLED patents, and the level of industry wide investment in the commercialisation of the technology to date, CDT received a US$15 million loan from Lloyds TSB, a corporate bank based in the United Kingdom, in July 2004. As in the case of the ATD loan, the loan to CDT was fully guaranteed by a credit enhancement firm and originator of IP collateralisation transactions. In the absence of the credit enhancement, CDT would have been eligible for a loan only against its traditional collateral: property, plant and equipment, accounts receivable and inventory, which would probably have necessitated a costly, time consuming and dilutive capital raise.

It is important to note that the US$15 million loan and credit enhancement facility represents but a fraction of the total value embedded in CDT's portfolio of patents, as the loan guarantee commitments only support extremely conservative loan advance rates. The credit enhancement firm used conservative loan to value ratios and short transaction tenors (typically three years) to hedge its risk in valuing and underwriting the IP and to ensure the timely remarketing of the IP in the event of a default and foreclosure on the note collateralised by the IP.

### Wise Foods Inc

Wise Foods Inc (Wise) is the premier regional salty snack company in the United States. Founded in 1921, Wise has a strong position on the East Coast, particularly in the north-east, and is now the largest regional manufacturer of salty snacks, holding a number two branded and private label position within its target markets.

The primary transaction collateral is made up of all of Wise's IP, including its trademarks, patents and copyrights. As part of its IP underwriting and collateral valuation process, the credit enhancement firm Wise worked with commissioned an experienced third party consumer brand valuation expert to provide a base line orderly liquidation value of Wise's trademarks as of August 2004. Using this orderly liquidation value as a baseline for further analysis, the credit enhancement firm's internal valuation team adjusted the final collateral underwriting valuation upwards to reflect Wise's ongoing rebranding of all of its sub-brands (ie, Cheez Doodles®, Quinlan®, New York Deli® and Bravos®) with the Wise name, its recent introduction of a line of healthy products under the Wise Choice® brand, and the value of Wise's patents and trademarks, which were not taken into account by the third party valuation firm.

The credit enhancement was used to support a US$7 million IP-based term loan for Wise. The IP-based term loan is part of a US$43 million senior secured credit facility. The credit enhancement firm's collateral for the credit enhancement consisted of a first lien on all of Wise's IP including its trademarks, patents and copyrights, and a second lien on all Wise tangible assets, including property, plant and equipment, accounts receivable and inventory.

### BCBG Max Azria Group Inc

BCBG Max Azria Group Inc (BCBG), headquartered in Vernon, California, was founded in 1989 by Max Azria. BCBG is engaged primarily in the design, production, marketing and distribution of contemporary women's fashion apparel, footwear and accessories under the BCBG Max Azria, BCBG Girls, Parallel, To the Max and Herve Leger trademarks. BCBG receives revenue from company-owned domestic retail stores, international company-owned and third-party retail stores, several major licensees and numerous wholesale accounts (mainly upscale department stores such as Bloomingdale's). BCBG is possibly the only contemporary brand to have developed the marketing strategy, diversity of product, distribution scope, and consumer recognition to evolve into a true lifestyle brand in the manner of Ralph Lauren or Calvin Klein. The BCBG Max Azria brand has become synonymous with young, fun and fashionable apparel, footwear and accessories marketed by innovative advertising and celebrity spokespersons. With critically acclaimed collections, a loyal following among Hollywood's top celebrities and a strong worldwide presence, the company has evolved into one of the strongest names in the fashion industry today.

BCBG, the holder of the core BCBG Max Azria brand and associated family of trademarks, patents and copyrights, is seeking to increase revenue and build brand awareness and trademark value by pursuing a thoughtful and prudent licensing strategy. The value established around the BCBG name over the last 14 years has clearly established strong brand identity, but the development of strong licensing relationships in key product categories – such as eyewear, shoes, watches and fragrances – will leverage the brand's historic identity and drive top line growth across multiple categories. Further, the efficient management of the brand's expansion into menswear will also be greatly facilitated through a thoughtful and well managed licensing strategy.

Not only is the licensing strategy driving new value for the BCBG intellectual property, but it is also facilitating the formal collateralisation process by establishing a set of revenue streams that may be readily transferred to a credit enhancement firm in the event of a default and foreclosure. Further, the successful licensing programme is validating the licensability of the brand and its onward revenue potential while establishing a path to potential additional licensing or sale of the marks and associated IP in categories currently controlled and managed internally by BCBG.

In December 2004, the credit enhancement firm extended a US$12 million credit enhancement to support a US$53 million asset backed note issuance by BCBG. The transaction was structured with US$41 million in non-credit enhanced notes (the Class A-1 notes) and US$12 million in credit enhanced notes (the Class A-2 notes). New York Life Investment Management (NYLIM) was the investor in both the credit enhanced and non-credit enhanced notes. The credit enhancement firm's US$12 million credit enhancement (in support of the Class A-2 notes) has a first priority perfected lien in all of BCBG's present and future IP, and shares the collateral on a *pari passu* basis with the Class A-1 notes.

## Conclusion

From the foregoing, it is apparent that the emergence of IP collateralisation is enabling IP-rich small to mid-cap companies to leverage their IP and gain access to debt capital to facilitate growth. Through the provision of IP-collateralised debt capital, either through direct lending or credit enhancements such as those offered by IPI, lenders can remain in their comfort zone while being afforded the opportunity to expand their lending portfolios with new and existing clients.

IP will not become a recognised asset class for asset-based lenders overnight, but the intercession of entities like IPI will go a long way towards achievement of a necessary precursor step, the assessment and management of risks associated with IP as an asset class. In turn, such credit enhancement entities willing to take risks associated with IP will enable IP collateralisation to join licensing, factoring and securitisation as effective vehicles to unlock the value of a company's key intangible asset: intellectual property.

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*Previously, he was senior vice president of strategy, business development and licensing for Cambridge Display Technology (CDT), where he stewarded CDT's transformation from a 35 person start-up with less than US$500,000 in revenue in 2000 to a recognised technology and revenue leader in Europe in less than 24 months. Prior to joining CDT, Mr Bergelt served as general manager, strategic intellectual asset management and director of corporate strategy for Motorola.*

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