The keys to raising IP-backed finance

There are a number of globalisation trends driving reliance on intellectual property. One important question for companies is how they should consider this in their own capital structures

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Many macroeconomic trends are driving the value of companies in developed countries to be increasingly affected by the value of their intellectual property portfolios. These include factors such as market capitalisation, accounting standards and asset value.

This article will explore those macro trends and how they will impact companies of varying sizes, creditworthiness and sophistication as they seek to adapt to this new model and use it to optimise their capital structure. The various financing markets to finance such pools of intellectual property include asset backed securitisation, bank debt, second lien loans, hedge funds and private equity. The attributes of each market will be described as well, so as to provide some education as to which market may best match various companies depending upon the characteristics of their IP pool and their overall business attributes.

Macro trends affecting value for shareholders

The macroeconomic and cultural trends affecting the asset base and value drivers of companies in developed countries include:

- The explosion of technology in areas of healthcare, manufacturing and entertainment, driving value from an asset-based model to an IP-based model with royalties and licences.
- A transformation of Western economies from a manufacturing base to a collection of companies delivering competitively priced products with leading class technology tapping into offshore lower cost manufacturing and assembly providers.
- Reshaping of consumer attitudes to demand low cost products as buyers (the Wal-Mart effect) while desiring high standards of living as employees.
- The ease of transferring information through the internet and other modes of communication, potentially shortening product lifecycles and competitive advantages.
- New global capital standards for regulated banks will steer such banks to lower risk, higher rated loans and push riskier or harder to measure products into the capital markets.
- Flows of capital across risk spectrums and country borders as evident by global lending, the explosion of hedge funds and private equity firms, and the resulting impact on the availability of capital for new and innovative ideas.
- Excess liquidity in the global systems today is forcing investors to seek additional yield and is driving a larger percentage of institutional capital into the alternative investment categories of structured finance, mezzanine debt, hedge funds and private equity.
- The interdependency of countries participating in the global economy is driving such countries to similar standards of technology, fewer currencies and legal systems that have more in common.
- Due to many of the factors above, the growth of emerging powers in China and India and the challenges of enforcing intellectual property rights in their legal systems.
- Global political issues, including war and shifting political alliances.

These factors are affecting companies large and small, in the United States, Canada, Europe, Japan, Australia and other developed regions, as each company and country is seeking to compete for global business. The manner in which they react to such challenges will affect their ability to compete for capital in the global market, so targeting their cost of capital and ability to compete overall with firms that are focusing on these trends today will be critical.

Despite increasing recognition of the importance of intellectual property by management and industry experts, the amount of capital raised directly based upon IP value has been relatively low, showing that a lot more work still needs to be done to broaden the market.

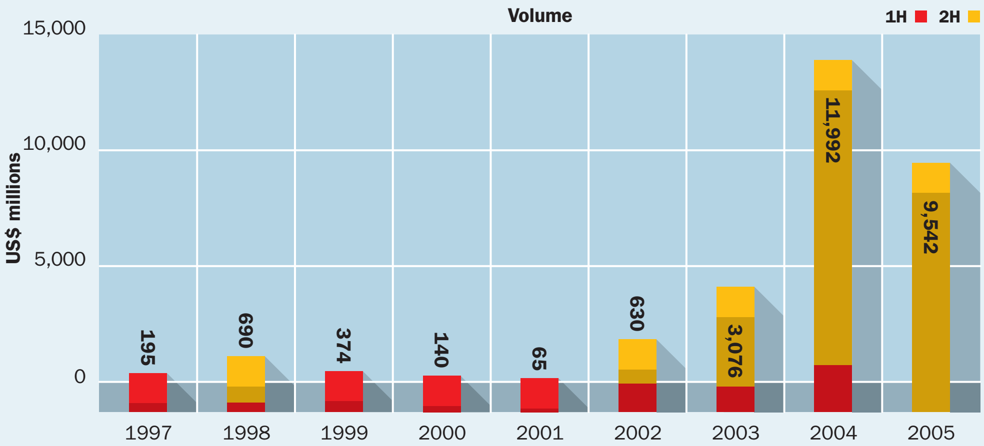
Decision on whether to and how to finance IP

The methodology and markets used to finance intellectual property are heavily dependent upon several factors, including a company's objectives, its embracing of the steps required to maximise value of the IP, an allocation of resources to get the transaction done, education among stakeholders (internal and external) to explain the value of such financing vehicles and, most importantly, a commitment by senior management to highlight the need to identify, account for, track and maximise the utilisation of intellectual property assets on behalf of company shareholders.

Companies may pursue financing of IP assets for many reasons, including:

- Increased leverage or longer term maturity. Depending upon a company's creditworthiness as a corporate entity, it may be more attractive to finance the IP assets on a basis that is predicated mostly or entirely on the performance of the IP assets with little or no recourse to the corporate parent. This may lead to higher leverage or longer maturities when compared with traditional debt methods available to corporations (bank debt, bonds).
- Off balance sheet treatment. While off-balance sheet treatment is pursued less often than in years past, some issuers may still pursue financing of IP in a manner that gets the assets off their books from an accounting standpoint while allowing them to benefit from the cash received in the deal.
- Minimising cost of issuance. Financing on the strength of intellectual property assets may be attractive for private companies, leveraged companies or those with debt ratings at or below A/A2 or its equivalent from the rating agencies. Investors in these transactions are relying on the performance of the collateral (the IP) rather than the general creditworthiness of the borrower, which may lead to lower all-in costs of execution.
- Transparency. Some companies may prefer to demonstrate that they are serving shareholders well by effectively tranching the risk of the corporation, issuing capital at the most effective terms. By financing on the back of IP assets at attractive terms relative to how the overall corporate entity could issue, management should be improving the overall capital structure of the company by highlighting the value of such assets in a quantifiable manner that leads to investor buy-in.

Second lien loans



Once a company decides to finance a transaction with all or part of the recourse dependent upon IP, it has several markets to tap to fund the deal. In some cases, a single transaction may include multiple sources of the capital mentioned below.

Asset backed securitisation (ABS)

This senior secured debt product looks to finance assets on a non-recourse and bankruptcy remote basis from the parent company of the IP. Such deals can be structured as revolvers, term loans or amortising bonds. The IP is transferred to a special purpose vehicle, which subsequently raises the debt allowed from either asset backed commercial paper conduits, institutional asset backed bond investors or both. The ABS market is very large and established (over US$2 trillion of issuance in the US from 1st January to the beginning of September 2005, for example) and is well-received and understood by investors. It does require larger transaction sizes (it has minimum floor of US$20 million and IP ABS deals have been completed to raise in excess of US$1 billion) and is expandable to a size as large as the assets can support. It is usually the lowest cost form of financing for issuers.

Bank loans

This senior secured debt product is provided by the traditional money centre banks and increasingly by collateralised loan obligation (CLO) managers and other institutional investors. The deals can be revolvers, term loans or both. While the bank loan market is very established, its participation in the intellectual property sector has been somewhat limited or the IP has been seen as a second method of repayment in support of general corporate obligations. Sizes in this market can vary but deals need to be syndicated as the risk is borne on the banks' balance sheets and is subject to legal lending limit restrictions.

Second lien loans

Second lien loans are a subordinated instrument and are a sector that has grown from US$195 million in 1997 to US$9.5 billion thus far in 2005.

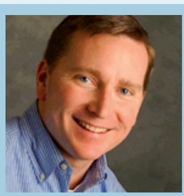
The growth of this market has been driven by its largest investors: hedge funds. According to some industry players, hedge funds make up 70% or more of second lien loan buyers in second lien deals between US$30 million and US$250 million. Hedge funds see second lien loans as a more attractive investment than high yield bonds or senior bank debt in that they may have more say in a distressed situation than high yield and other subordinated note holders and are getting yields that are 300 to 400 basis points wider than senior debt. This market will face an interesting test when the credit cycle turns, as it always does.

Hedge funds and private equity funds

Hedge funds, private equity funds and other opportunity funds often finance stub pieces of IP transactions along with the debt instruments mentioned above, or if the market is very young and inefficient, they take the entire transaction and turn around and lever it

Raising money with IP

Solutions	Deal size (Capital from Funding Source)	Investors	Overall cost	Complexity	Rating agencies involved?	Legal protections	Understanding of IP as collateral	Time to close	Valuation required?
Asset backed Securitisation	Large (US$20million or greater, can exceed US$1 billion)	Commercial paper conduits, pension funds, insurance companies	Lowest	High	Yes	Detailed	Primary repayment source, intimate knowledge	Longer	Yes
Bank debt	Small-mid size (US$2-US$50million)	Large and mid-size banks	Low-medium	Medium	Maybe	General filings	Often secondary form of collateral	Medium	Maybe
Second lien Loans	Small-mid size (US$2-US$50million)	CLO investors, hedge funds	Medium	Medium	Maybe	More detailed than general bank debt	Better than senior lenders	Often parallel with bank debt	Most likely
Hedge funds	Small-mid size (US$2-US$50million)	High net worth investors, pension funds, insurance companies, endowments	Medium-high	Medium	Usually not	More detailed than general bank debt	Better than senior lenders	Shorter	Maybe, depends on collateral and cost
Private equity	Small-mid size (US$2-US$50million)	High net worth investors, pension funds, insurance companies, endowments	High	High	No	More broad as investment secured by overall returns rather than liquidation of collateral	Better than senior and mezzanine lenders, hold seat on board of company	Longer	Maybe, depends on collateral and cost



themselves at a later date. These investors obviously have a higher return requirement, providing issuers with incentives to attempt to tap the markets listed above and fill in any gaps if necessary with third party equity and mezzanine players.

Challenges

Given the growing recognition of IP as an asset to be monetised, there are a number of factors for companies to consider when looking into the financing mechanics mentioned earlier, including:

- Size of the company as measured by sales and cash flow.
- Diversity of the streams being generated by the intellectual property (assuming the IP is in market and creating value today rather than a venture capital or early stage IP asset).
- Number and location of countries in which IP is located.
- Legal systems and enforceability in such countries as it relates to perfection and recognition of intellectual property.
- Technology or other obsolescence risk issues.
- Future support (cash, technological or service) required from IP owner to collect royalties or licence fees.
- Valuation metrics used to determine IP valuation and volatility of such values.
- Liquidity (or lack thereof) for IP streams in the secondary market.

There are also several challenges that, if not met, could impede improved access to capital provided for IP pools.

Internal fiefdoms that prevent the cooperation of resources required to maximise the value of intellectual property are a particular problem. It is vital that there be cooperation between legal, tax, treasury and product development/engineering functions to accomplish this successfully. In the same way, a lack of pressure from shareholders or boards of directors, or a lack of best practices to determine how to maximise IP valuation without eroding competitive advantages due to secrecy of IP, will also prove problematic. A change agent is required to demand accountability, whether in the form of an executive or challenge from shareholders It is also important to be aware that accounting issues in this area are complex and developing, while enforceability differs in different jurisdictions.

What needs to happen?

Intellectual property has parallels for some companies to information technology in the late 1980s and early 1990s. At that time IT was seen as a cost centre rather than a source of competitive advantage. Investments were often not made or tracked relative to the returns that they produced in workplace efficiency, manufacturing savings or improved customer service, and as such the investments did not reach their full potential. Today, many CFOs and CIOs are working together and often share reporting lines to ensure that IT investments are bearing fruit. Why should IP be any different? Leading edge companies and their stakeholders need to demand that IP be treated as an asset that is accountable, capable of being tracked and subject to the same demands from a return on equity standpoint as any other investment and capital expenditure.

Markets are often helped by the development of best practices and shared experiences. The pooling of information can lead to deeper capital market acceptance of IP as an asset and open the spigot for additional investment. Publications such as this magazine are helping discuss IP, but other broader based publications such as widely read business newspapers and business magazines appealing to chief financial officers, chief executive officers, general counsel members, and members of boards of directors should raise the topic in detail to demand greater discussion and accountability for these investments on the behalf of shareholders.

As more deals are done, more data becomes available for distribution and more investors are willing to accept transactions by using IP as some portion of the basis for their investment. Emerging financial markets are usually initially driven by higher risk investors such as private equity firms, hedge funds, institutional investors and high net worth individuals. Over time and with successful early transactions, the overall market becomes deeper and cheaper for issuing companies as lower cost debt providers play a bigger role in the transactions.

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Prior to joining Harris Nesbitt Corp, Mr Walsh worked as an originator for Union Bank of Switzerland out of its Chicago office, providing commercial and investment banking products for Fortune 300 clients in the Midwest. He began his career in corporate banking with Continental Bank in Chicago.

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