Monetisation of IP royalties and revenue streams

New monetisation techniques such as royalty interest sales, revenue and royalty interest financings and IP securitisations are generating increased investor interest

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As the field of IP monetisation continues to mature, monetisation techniques are also evolving. One area of increasing interest is monetisation of royalties and revenue streams generated from intellectual property. This increased interest has several drivers.

First, as IP monetisers have successfully executed licensing programmes with recurring royalty payment streams, a natural question arises as to whether any further leveraging can be made of those royalty streams. Similarly, certain rights holders which in recent years began to take a hard look at the monetisation potential of their patent portfolios are now broadening their focus to other IP-based assets.

Second, there is increased interest in IP investments by mainstream institutional investors reaching for yield and looking for alternative investments. These investors are generating demand for IP investments; IP payment streams can be appealing as they are one level removed from the arcane complexity of IP rights and similar to other payment streams with which such investors are familiar.

Third, significant experience has been accumulated with royalty and revenue stream investments in the pharma/biotech, music, consumer brands and fast-food/franchising sectors, making an expansion of such techniques into more general use a natural progression.

Monetisation techniques that are associated with IP royalties and revenue streams include:

- royalty interest sales;
- revenue and royalty interest financings; and
- securitisations.

Monetisation of IP payment streams: overview

Suitable payment streams

An initial consideration in IP payment stream monetisation is that not all such payment streams are suitable for a monetisation transaction. The royalty or revenue stream must be large enough and likely to remain stable or grow for a sufficient period of time to justify the risks and transaction and opportunity costs involved. In certain circumstances, multiple royalty streams can be bundled in order to structure a large enough deal value. Such bundling can make a transaction feasible and potentially diversifies the investment vehicle, but at the price of increased complexity.

Due diligence and risk assessment

The risks associated with the IP payment stream must be manageable. Due diligence and assessment of commercial, legal, regulatory and investment risks and other considerations can be complex. Risk factors generally affecting future cash flows include:

- sensitivity of the revenue stream to changes in consumer preferences;
- technological, product and market segment obsolescence;
- risk of invalidity or unenforceability of intellectual property;
- IP infringement risk;

- contract interpretation and enforceability risk;
- risk of changes in IP, regulatory or other law; and
- moral hazard.

The above risk factors apply generally to IP-based royalty and revenue streams, such as where a small company licenses a technology to a larger company and then sells an interest in the royalties to an investor. Interestingly, where the royalty stream being monetised is under a licence that results from an IP enforcement action, the risk profile will often be materially reduced, given that the underlying intellectual property would have survived invalidity, unenforceability and non-infringement challenges in the enforcement action.

Valuation/pricing

As with the sale of patents and other intellectual property, valuation and pricing can present challenges for IP royalty and revenue streams. Generally, the sale price of the royalty interest will be the discounted future royalties, adjusted for risks, contingencies and other factors. The parties may materially differ on the appropriate discount rate and on the proper assessment of the factors affecting valuation. In addition, IP valuation techniques are still maturing, introducing further uncertainty. One factor that can mitigate the complexity with respect to IP payment streams is that the amount paid by the royalty payor has been set, unlike with patents where the value of the intellectual property is usually highly context specific. The key issue becomes the appropriate discount rate and any material adjustments to the price to address associated risks and other material factors. Finally, valuation and pricing for a transaction are not undertaken in a vacuum; the relative costs of and value generated from other sources of capital can also be a material factor.

Transaction structuring complexity

Various factors can influence the complexity of an IP payment stream transaction, including:

- the number and nature of royalty-generating assets;
- the requirements or circumstances of payment-generating contract(s) of any underlying in-bound licences and of the royalty-paying contractual counterparty;
- the characteristics of the IP payment interest being structured;
- the type of deal structure used and the number of investors involved (and the tax and other deal structuring requirements that each may have); and
- the extent and nature of structural bankruptcy protections and credit enhancements used.

Specific royalty and revenue monetisation techniques

Basic models for royalty interest purchases, revenue interest financings and IP securitisations are discussed below. In practice, the techniques blur into each other to varying degrees. Substantial flexibility in structuring is usually possible. Moreover, hybrid transactions that include more than one of the techniques to monetise a royalty or revenue stream, or one of the techniques combined with equity or other monetisation and financing mechanisms, are also possible.

Royalty interest purchases

A royalty interest purchase is conceptually straightforward. The rights holder sells its rights to royalties generated under a licence to an IP asset, usually in return for an upfront lump-sum payment. Historically, sales of royalty interests have mostly involved patents and have been used primarily by universities and small to mid-sized companies seeking access to capital and by individual inventors.

Basic structure

Figure 1 is a simplified diagram of the steps involved in structuring a royalty interest purchase:

- The rights holder has a royalty stream pursuant to one or more licences that are determined to be appropriate for a royalty monetisation. Key considerations are that the royalty stream meets the investors' investment criteria, due diligence is completed satisfactorily and risks appropriately managed, and the parties reach agreement on valuation and price of the royalty stream.

- The rights holder assigns the right to all or a portion of the stream of future royalties to the investor.
- The investor pays an upfront lump sum to the rights holder for the rights to the future royalties.
- Royalties received are deposited directly into the investor's account or a 'lockbox' (ie, a holding account).
- If a lockbox arrangement is used, royalties are allocated and disbursed from the lockbox according to each party's respective interest in the royalties.

As noted earlier, significant flexibility is usually possible in structuring royalty interest purchases. For example, all or only a portion of the royalty stream may be sold, and the royalty interest can be tiered or reversed tiered. There is flexibility as to the products, geographic areas and time periods that are included or excluded from the acquired royalty stream; there can be buy-out options; and dollar caps can be imposed on the purchased royalty interest to allow the rights holder to retain an equity up-side component if the royalty stream proves to be significantly larger than anticipated (eg, an investor that pays $50 million for 40% of a royalty stream might agree to be capped at $150 million in royalties collected). Retention of an up-side component can be important, as sellers have been deterred from selling royalty interests due to a fear of underselling what eventually turns out to be a blockbuster royalty stream.

Pros and cons for rights holder

Advantages of royalty interest sales for the rights holder include:

- acceleration of royalty stream into immediate capital;
- competitive cost of capital in certain circumstances;
- non-dilutive to equity;
- the shift of risk of royalty stream disruption or underperformance to the investor;
- flexibility in defining the royalty stream sold; and
- retention of an equity component in the royalty stream.

Disadvantages for the rights holder include:

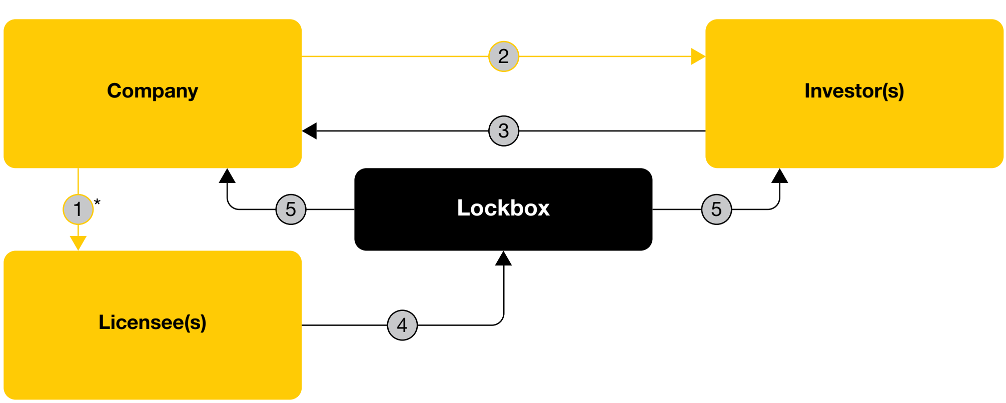
- loss of stable, long-term source of cash flow;
- dilutive to earnings;
- high discount rates to compensate for risks;
- no retention of equity component in royalty stream (in sale of 100% of royalty stream); and
- potentially substantial expenses and time associated with due diligence, valuation and transaction structuring.

Pros and cons for investors

Advantages for the investor include:

- provision of an alternative channel for deploying capital;
- the ability to focus investments on

Figure 1. **Structure of a royalty interest purchase**



> "In certain circumstances, multiple royalty streams can be bundled in order to structure a large enough deal value. Such bundling can make a transaction feasible and potentially diversifies the investment vehicle, but at the price of increased complexity"

particular attractive assets; and
- potentially high returns due to the discount rates and equity component in purchased royalty stream.

Disadvantages for the investor include:
- the risk of royalty stream disruption and underperformance; and
- potentially substantial expenses and time associated with due diligence, valuation and transaction structuring.

Revenue interest financings

Revenue interest – or 'synthetic royalty' – financing involves transactions in which a company receives cash, typically a lump-sum upfront payment (with possible additional funding on hitting milestones), in return for a revenue interest on product sales. The revenue interest is typically set at a percentage of revenues generated from a specified portion of the sales of identified products for a specified period. In a typical scenario, an operating company requires capital to finalise development of and commercially launch a technology product. The investor provides funding in return for a percentage of the revenues generated from sales of the product, once launched, for a specified period.

One specialty investment firm (Paul Capital) characterises revenue interest financing as a financing alternative somewhere between debt and equity.

Relative to equity, revenue interest financing is non-dilutive to equity and can provide a lower cost of capital, and a company's valuation and public market indicators play a less significant role.

Compared to debt:
- the financing terms are not as sensitive to current credit market conditions, since payments to the investors are driven by the product's sales;
- the aligned interests of the company and investors in higher product sales reduce the need for restrictive operating and financial obligations; and
- payments are based on how well the financed products in the deal sell, rather than a fixed interest coupon.

Basic structure

The conceptual process and structuring mechanics of revenue interest financings are quite similar to royalty interest purchases. The diligence and valuation process is generally similar. Also, as with royalty interest purchases, significant flexibility is possible in structuring a revenue interest financing, including as to scope of products, geographic areas and time periods in defining the revenue stream, as well as mechanisms to retain an equity up-side component, including through caps on payments to investors and repurchase rights. One important difference is that synthetic royalties have been typically structured as debt.

Pros and cons

Revenue interest financings have substantially the same advantages and disadvantages for rights holders and investors as royalty interest sales. Potential additional advantages are the treatment of the revenue interest financing as debt (thereby avoiding taxes on the amounts raised) and contract terms that are less restrictive than traditional loans. A disadvantage for the rights holder is that a security interest is typically granted on the underlying IP assets.

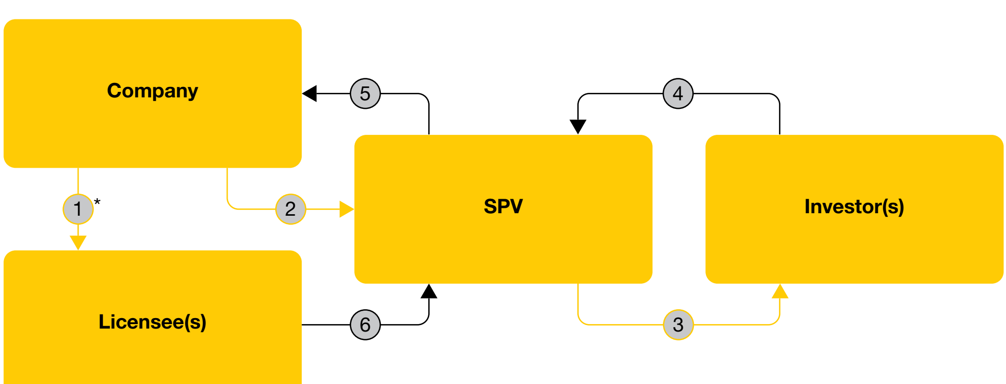
Royalty interest financings
Royalty interest financings are financing transactions collateralised by royalties. Conceptually, royalty interest financings share similarities with revenue interest financings, except that royalty interest financings are commonly structured as fixed interest loans, rather than variable interest payments based on product sales. Loan contract documentation for royalty interest financings tend to be structured similar to conventional loans, with appropriate adjustments for the nature of the royalty interest collateral. The underlying intellectual property that generates the royalties may or may not be included in the collateral package, depending on the circumstances.

IP securitisations
An IP securitisation is a royalty or revenue interest financing undertaken by means of a securitisation. In an IP securitisation, the rights holder transfers rights to royalty or revenue stream payments by issuing notes or other securities, usually through a special purpose intermediary entity.

Basic structure
The structure of an IP securitisation shares similarities with royalty interest purchases and revenue interest financings, but has important differences and additional complexity. Figure 2 is a simplified diagram of the steps involved in structuring an IP securitisation:

- The rights holder has a royalty stream under one or more IP licences and underlying assets that are determined to be appropriate for a securitisation. The rights holder and the investor agree on the valuation and pricing for the receivables/intellectual property.
- The rights holder creates a bankruptcy-remote special-purpose vehicle (SPV) and sells the royalty-generating assets to the SPV. The sale of the royalty-generating assets to the SPV must be a 'true sale'. Depending on the circumstances, transferred assets may or may not include underlying intellectual property.
- The SPV issues debt securities to investors which pay a coupon, with amortisation over a set period. The debt securities typically receive a credit rating. Credit enhancements are often used to improve the credit rating of the securities, including:
  - over-collateralisation;

Figure 2. **Structure of an IP securitisation**



- holdback/debt reserve accounts; and
- appointment of a back-up manager in the event of the company's failure

The use of credit enhancements, the restriction of the securitisation to royalties or receivables of relatively high-credit quality and the isolation of the assets in a bankruptcy-remote SPV typically result in a credit rating for the securities that is higher than that of the rights holder. This can facilitate a lower cost of capital for the funds raised from the securitisation than would otherwise be obtainable and/or a higher loan-to-value ratio.

- Investors pay a lump sum to the SPV for the debt securities.
- The SPV pays the company a lump sum for the purchased assets. The net capital raised by the company typically will be the sum paid by the investors, less transaction costs, debt reserves and other credit enhancements (if used) and other possible deductions.
- The licensees' royalty payments are used to service the debt obligations during the term of the securitisation.

Pros and cons

Advantages for the company include those of a revenue interest financing, with the additional advantage of potentially higher credit rating on the securitisation than the company's credit rating, thereby reducing the cost of capital and/or improving the loan-to-value ratio (and thus the amount of capital raised).

Disadvantages for the company are the same as for a revenue interest financing, with the following additional qualifiers:

- for IP securitisations, potentially substantially increased effort for due diligence, valuation and risk assessment and structuring; and
- for credit enhancements and other protective measures, significantly increased transaction costs and a reduction in the net capital to the rights holder.

Advantages and disadvantages for the investor are substantially the same as for a revenue interest financing, conceptually, although participating in a securitisation through the purchase of notes is easier to invest in than undertaking a specific revenue interest financing or royalty interest purchase.

Conclusion

Royalty interest sales, revenue and royalty interest financings and IP securitisations are monetisation techniques that are proven effective tools in appropriate circumstances. As IP monetisation activity continues to expand, there will be an increasing number of opportunities to leverage these tools to the mutual advantage of rights holders and investors. iam

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Mr Esteves is a graduate of Yale Law School and holds a master's in electrical engineering from Columbia University. Before law school, was a computer engineer for three years at IBM.