Leveraging Intellectual Property via the Capital Markets

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Relatively few organizations appreciate the full scope of flexibility available to them in terms of unlocking the value of their patents, trademarks and other intellectual property. One of the most overlooked methods for utilizing the value of IP is its use as collateral. This activity is becoming more common as the importance of proper intellectual property management gains recognition and as increased cash flows associated with the licensing of IP catches the eye of Wall Street. The highest profile examples of these transactions are probably the securitized royalty streams on the copyrights owned by famous songwriters like David Bowie and James Brown. However, there have been numerous instances of valuable trademarks and highly productive patents being utilized in this capacity as well.

There are a number of reasons why an IP owner might be interested in pursuing this kind of strategy. First, it can provide a method for transferring some of the risk associated with the intellectual property. If the financing is non-recourse, the risk of receiving the royalty payments is transferred to the lender. Also, any risks associated with infringement and obsolescence are transferred as well. Second, it may increase the return on the IP through increased leverage. This is because the present value of impending royalty streams is being collected in a lump sum today rather than spread out over the future. This lump sum payment can then be invested in current projects that feature an internal rate of return that is higher than the cost of the financing. Any upside potential residing in the IP is typically retained by the IP owner as well.

Third, it provides a source of capital that does not dilute the current equity structure. With venture capital discounts typically in the range of 25% to 50%, this is very beneficial when compared to equity sources of financing, especially for smaller technology companies. An additional benefit of this kind of financing is that the interest payments are tax deductible. This helps to offset a portion of the discount taken as a result of the present value analysis.

For the purposes of this discussion, intangible assets fall into one of two categories: those with specifically identified cash flow ("Cash Flow Assets") and those with implicit value. The Cash Flow Assets are typically assets such as trademarks, patents or copyrights that have been licensed. With these assets, the royalty payments from the license agreements are attributable to the licensed assets. Those with only implicit value may include trademarks and patents that are only used internally and obscure intangible assets such as customer lists, non-compete agreements and proprietary packaging designs.

While there are instances of lending against the assets without accompanying royalty streams, usually only the Cash Flow Assets will generate any interest from lenders. This is

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because the two primary concerns for the lender are that the funds loaned are secured by sufficiently valuable collateral and that there is sufficient cash flow available to service the loan payments. When financiers do lend against implicit value assets, they want to understand the value as it is used by the owner and also its potential value in the lender's hands should he have to foreclose on the loan.

With the Cash Flow Assets, there are several aspects of this kind of financing that it is important to understand. First, the financier is primarily interested in the cash flow: How long has it taken place? Has it been consistent? Is it growing? What are the potential obstacles that may arise? Because the lender is focused on the cash flow and his likelihood of being repaid, it is the credit rating of the licensee that is of importance, not that of the IP owner. The licensee is the ultimate source of the cash flow that will be used to repay the loan. In fact, a small entrepreneur that licenses to a large stable corporation with a great credit rating is likely to get a more favorable interest rate than a more established player that licenses to an organization without an exemplary credit history.

Second, lenders will prefer to have the assets reside in a wholly owned subsidiary that has a totally separate operation from the IP owner. Referred to as a Special Purpose Vehicle or Entity ("SPE"), these holding companies serve to protect the lender against the possibility that the IP owner will file for bankruptcy protection. If there is not a SPE already in place, setting one up should be one of the first steps taken.

Third, similar to most lending activity, an escrow account will likely be required. Unlike other loans with which you may be familiar, the escrow account will remain a vital part of the payment activity throughout the life of the financing. The mechanism is fairly straightforward. All royalty payments made by the licensee are paid into the escrow account. From these proceeds, the amount required to service the loan is paid to the lender. Any funds beyond that are paid to the SPE, which may then use them in the management of the intellectual property or may pass them on to the parent organization.

Finally, the due diligence agenda associated with this kind of financing is likely to be much more extensive than other lending activities. It will likely consist of legal items such as title searches and patent validity, financial items such as valuation and cash flow verification and analysis, and technical items such as obsolescence potential, current and potential competition, and product life cycle. All of these will have to pass a thorough inspection before the financing will go forward.

Conclusion

Intellectual property value is more readily available for strategic use than ever before. Whether the IP owner is interested in a straightforward loan using valuable trademarks and customer lists as collateral or in securitizing the royalty payments associated with licensed technology, there are options available today that will help to reduce risk, increase return and provide flexibility for the management of intellectual property.

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