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The financial future of intellectual property

IP has a vital role to play in stimulating economic recovery, according to **Martin Brassell**, chief executive of Inngot

The UK has seen a decline in traditional "asset rich" manufacturing industries, whose tangible property effectively underpinned bank lending. These industries have been replaced by today's knowledge economy businesses, where intangible assets (including intellectual property) account for a very substantial part of the value in the firm.

The scale of this value dependency on intangibles has been recognised in many reports, including the 2006 *Gowers Review of Intellectual Property*. The *Gowers Review* is now to be followed by a new assessment of the role of IP in the market: its terms of reference place a clear emphasis on the relationship between IP law and the ability of businesses (especially those working in the digital domain) to generate wealth and value.

If innovation represents the sustainable competitive advantage the UK and Europe needs, the time is right for lending policies and practices to be adapted to fit the workings of the knowledge economy, rather than expecting knowledge-based businesses to conform to templates left over from an industrial age.

The problem of innovation finance

While venture capital firms and business angels generally recognise the importance of IP in their investment decisions, bank lending against IP and intangibles remains undeveloped. This limits access to capital for growth and innovation in a knowledge-based economy.

Lending by banks and asset finance houses to SMEs is still heavily concentrated on traditional assets, namely property, equipment, inventories or receivables. Given that SMEs are predominantly reliant on bank lending or asset finance to raise capital, those companies with limited tangible assets are significantly impacted in their ability to access finance, due to the absence of suitable security.

The importance of this issue is acknowledged through the existence of the Government-backed Enterprise Finance Guarantee (EFG) scheme, recently extended for a further four years. However, the funding associated with EFG only runs to a maximum of around 6,000 businesses annually. In any event, the problem runs much wider than the typical profile of EFG applicants.

The consequences of having little tangible security to offer are particularly severe for organisations reliant on software. Problems experienced by the creative industries are currently the subject of a further review, announced in the Government's response to its recent consultation exercise, *Financing a private sector recovery*[1].

The quantum of value

In quoted companies, the value contribution made by intangible assets to corporate value is relatively easy to establish and the importance of developing a market to finance intangibles has also been recognised by the European Commission, which recently tendered for a report to be compiled on this subject through 2011.

In quoted companies, the contribution made by these intangibles is tacitly recognised in their market value. However, smaller unquoted companies have no comparable mechanism for them to measure or to demonstrate what intangibles are worth in their business.

The magic number

For intangibles-led financing to work, an appropriate mechanism has to be found to approximate the value of these assets, which typically are not valued other than under circumstances when they have been acquired (in which case IFRS3 requires the buyer to identify the assets and allocate value to each of them).

This is not an argument for bringing more IP and intangibles onto the balance sheet. Under most circumstances, only the cost of creation or acquisition can be accounted for in this way. Cost is, at many levels, the least satisfactory of the three principal methods used to formulate IP valuations (the others being market-based comparisons and models applied to present and future cash flows).

Working with specialist input from Grant Thornton UK LLP, Inngot's own research has concluded that the primary market requirement is for a consistent starting point when assessing the value of IP and intangibles. It concluded that, when looking to leverage the security value of IP, the "relief from royalty" approach is at least as appropriate as any other IP valuation method in relatively common use.

Defining the intangibles

Apart from the question of valuation, there are two key elements which need to be in place to unlock the value that is tied up in IP and intangible assets. The first relates to definition.

At present, where intangible business assets are affected in a regular lending transaction, it will be in the context of a floating charge. This offers a relatively low level of protection for a lender – if the assets are not separately identified it is hard to ensure that the lender can exercise rights over all of them should the business go into administration. If these assets are registered and classified, they can be leveraged much more effectively.

Greater leverage is achieved in the context of factoring and invoice discounting, where a supply contract is effectively being used as security. However, while this technique can be beneficial for cash flow, it does not provide a mechanism to inject funds for growth. To fully address the potential for this form of investment, the market needs something on the scale of the sale and leaseback mechanisms used to unlock value in tangible property.

Some experimentation has been done in this field, especially in respect of software. Where there is a clear relationship between the

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copyright in the software and the generation of income, there is potential to acquire the code and license it back to a business on an exclusive basis for a limited term, thus freeing up working capital.

Software has a number of attractions in this context, not least the fact that it can be put into escrow where it can be tested and held on the lender's account. What has previously been lacking has been the ability to register these assets, along with a financier's interest in them.

A disposal mechanism

The second element is to improve the conditions under which value can be realised from these intangible assets if the company which owns or originates them gets into difficulties. These are the circumstances under which the security is likely to be "called in" and value will need to be realised from the assets related to it.

Broadly, a lender's options are to seek to dispose of the individual assets to the highest bidder, or to see the business transition into new ownership so that more value can be recovered. Given that the realisable value of a set of intellectual assets are linked to the health of the business holding them, that they are inter-related, and that they are likely to be worth more when taken as a whole, the second of these outcomes will generally be preferable. Here, having a fixed charge over specifically identified IP and intangibles (or even owning them already, as in the sale and licence-back example above) puts a lender in a strong position with an administrator seeking to sell a business as a going concern.

However, the effect of using intellectual assets as security is likely to be rather more profound than this "mechanical" advantage. Since assets like these are core to the means by which a knowledge-based business generates value, it can be argued that they provide a more powerful incentive to repay than almost anything else the company owns.

It should also be pointed out that lack of liquidity is not a problem confined to intangibles. The recent turmoil in the property market (which remains unsettled, particularly in the commercial sector) shows that disposal of tangible investments can also be problematic for lenders, depending on market conditions.

Equally, lenders sometimes choose to finance assets that clearly experience a radical decline in value the moment they are bought or installed – office furnishings and equipment being a prime example. The upside potential of IP (to appreciate in value where a company is well managed) is a feature not shared by many other assets in current markets.

Awareness of the opportunity

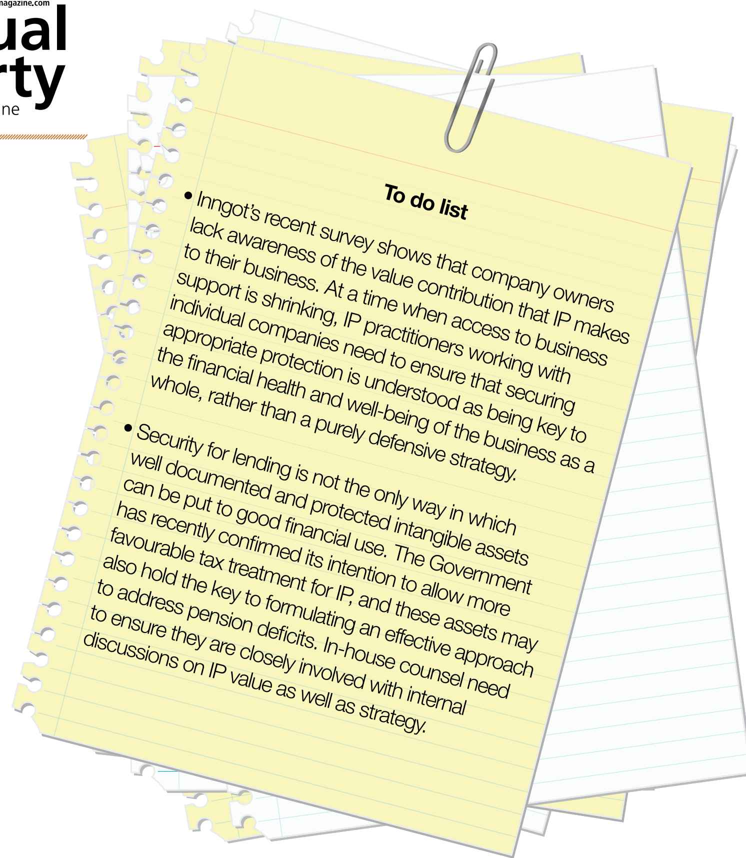
Clearly, work needs to be done to explore the concept of intangibles-based financing to lenders. But there is also an information deficit amongst business owners.

Inngot recently conducted its own survey, receiving nearly 1,200 responses to its poll of companies (mainly small and medium enterprises):

- Only 13% of respondents stated that they "didn't know" what the term "intellectual property" meant;
- Less than half of those surveyed – 42% – knew their intellectual assets and IP had a monetary value;
- 36% of company owners expressed an interest in finding out what their IP was worth; and
- Of this 36%, over one-quarter were motivated by increasing their business valuation, and just over one-tenth had a specific interest in using the information to attract funding and investment.

A question of balance

It is evident that, just as the Government is seeking to "rebalance" the economy (from a sectoral and geographical perspective), so the major lending institutions are seeking to address sometimes excessive exposures to tangible property. The combination of the new IP review, the various new funding and investment initiatives and the need for banks to find more effective forms of security, make this a particularly opportune time to explore and test the merits of obtaining security over the assets which are truly core to the means by which an organisation creates value.



The Athena Alliance has previously summarised the situation in the US as follows:

> As the US moves away from a manufacturing based economy and toward a technology-and -innovation driven one, intangible asset investments are becoming vital to economic growth and sustainability. Just as physical assets were used to finance the creation of more physical assets during the industrial age, intangible assets should be used to finance the creation of more intangible assets in the information age…
>
> Historically, companies have only been able to leverage funds based almost solely on their tangible assets. Now more than ever companies need to be able to tap into the value of their intangible assets as a source of business capital for critical innovation advancement and long term business development[2].

The UK needs to seize the current opportunity to consider this fundamental imbalance between sources of value and sources of finance, and formulate solutions that can open up access to capital on terms that can benefit lenders and innovators alike.

Footnotes

1. Financing a private sector recovery, HM Treasury/BIS, 2010
2. *Intangible asset monetisation*, Athena Alliance, 2008

Author

Martin Brassell is chief executive and co-founder of Inngot, the "innovation directory" established to assist organisations in unlocking the hidden value in their IP and intangibles. He previously spent 15 years in the information industry at companies including Equifax and HPI, prior to setting up a SEEDA-funded "Enterprise Hub" supporting high growth knowledge-based businesses. http://www.inngot.com