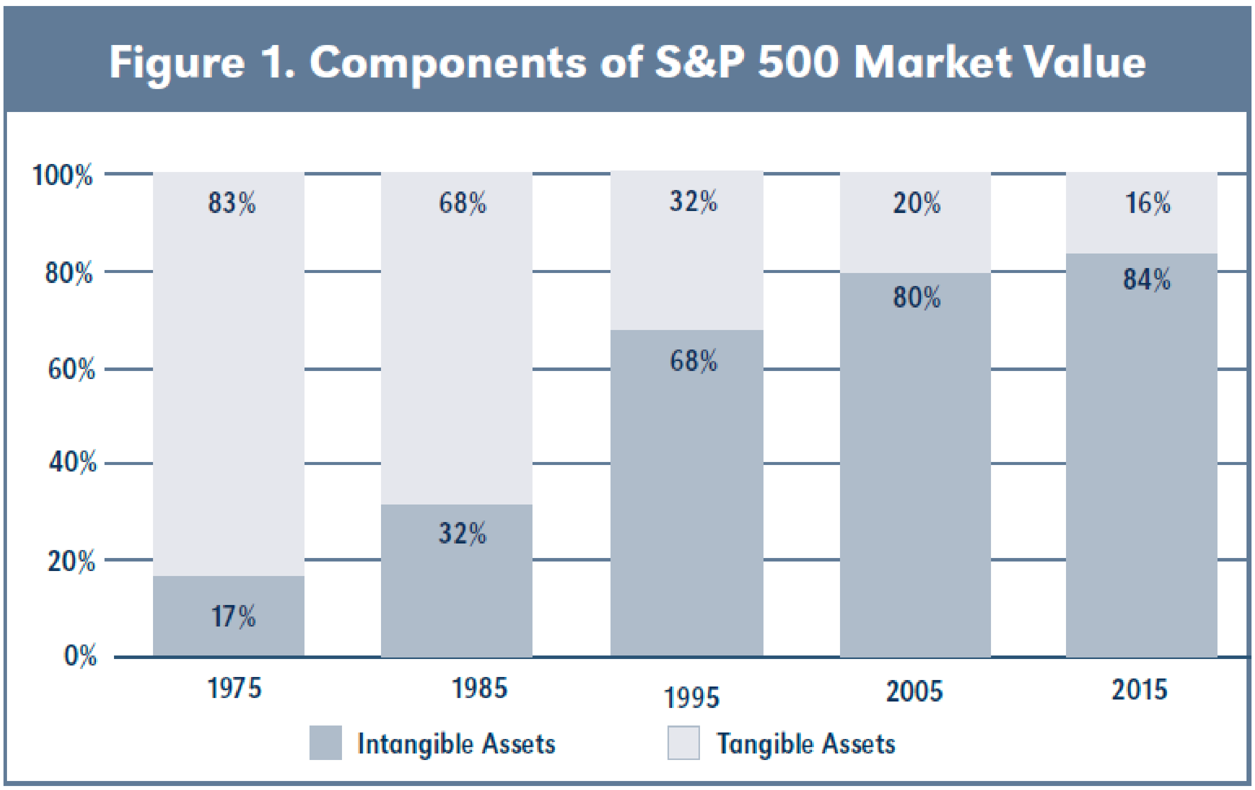
What You Should Know About Intangible Asset Finance

Why is Intangible Asset Finance Important?

Business owners, capital markets professionals, and trusted advisors should have a working knowledge of intangible asset finance because intangible assets are the rising asset class of the U.S. economy. Despite their value and importance, however, intangible assets are often overlooked and misunderstood. This article offers a high-level summary of different financial products and solutions for businesses with intangible assets operating in the modern service economy.

The Rise of Intangible Assets and the Service Economy

The U.S. has transitioned from an asset-intensive industrial economy to an asset-light service economy. Ocean Tomo, an intellectual capital merchant bank, published a study on intangible asset value and their findings are summarized in Figure 1. Physical or tangible assets comprised more than 80% of the S&P 500 Market Value in 1975 but in just 40 years the percentages had reversed.



The authors of the Ocean Tomo study, Cate M. Elsten, and Nick Hill note that the "role intangible assets play in corporate market capitalization… is a strong reflection of innovation in the greater economy." The capital markets has responded to corporate innovation with innovation of its own, specifically around intangible asset finance for formal intellectual property ("IP").

Formal IP is the best-understood segment of intangible asset finance and as a result, it has a collection of sophisticated financing and capital markets alternatives. However, informal IP, which is most often seen as a catch-all in the goodwill of a company's balance sheet, has received less attention and innovation from a financing perspective, despite comprising a larger part of the broader market's intangible asset value.

Before reviewing the various types of intangible asset finance, however, it's important to understand the difference between formal and informal IP.

What is Formal Intellectual Property?

Formal IP is generally broken into two categories:

- *Industrial Property* which includes patents, trademarks, and designs, and;
- *Copyright* which covers literary and artistic works such as novels, poems, plays, films, and drawings, among others.

The distinction between these two types of formal IP is that industrial property requires formal legal registration while a copyright is an "automatic right," which results simply from the creation of the original work. Metis Partners, a U.K. based intellectual property consulting firm whose work is referenced in this article, notes that "formally protected IP gives the IP owner exclusive rights to utilize and/or commercialize their innovation or brand, creating barriers to entry for potential competitors in the marketplace. It is essentially a legal monopoly, and one which can be enforced and defended in a court of law."

Types of Formal IP

There are generally four specific types of formal IP, as outlined by Metis Partners, and each largely stands alone as a unique asset class:

- *Patents*: A patent is a legal document that declares ownership of a unique technology or process which covers how things work, what they do, how they do it and how they are made. A patent provides an owner with the ability to take legal steps to try and stop others from using the invention without permission.
- *Trade Marks*: A trademark is an image which can take the form of words, logos, pictures or some combination of these. A trademark gives the owner legal rights to stop the use of similar images which may be confusing to the trademark owner's customers.
- *Design Rights*: A registered design applies to the appearance of a product and gives a legal right to protects its use.
- *Copyright*: A copyright provides the creator of an original work the exclusive rights to its use and distribution.

What is Informal Intellectual Property?

While a company cannot register its informal IP, these assets can be of equal or greater importance for a company's competitive advantage and valuation. "Trade Secrets" is the most well-known and understood category of informal IP. It is also a popular topic given the United States' effort to prevent the forced transfer of U.S. corporate trade secrets to foreign enterprises and governments.

There are other informal IP categories like customer and supplier relationships, organizational knowledge, and business processes which often enable or define a company's value proposition its customers. Understanding and articulating these informal IP assets can make a business more bankable, defensible and valuable.

Types of Informal IP

Metis Partners also describes eight types of informal IP and unlike formal IP, which are distinct assets in and of themselves, informal IP categories are often interconnected, if not inseparable, from each other.

- *Trade Secrets*: A trade secret is a formula, practice, processor or combination of items which are generally unknown and provide a company an economic advantage over its competitors or customers.
- *Organizational Knowledge*: Organizational Knowledge is a company's "know-how" which has been developed, documented and shared within a company. These may include training programs, systems, procedures, technical specifications or drawings.
- *Proprietary Software Code*: Proprietary Software Code is owned by the firm that developed it. Source code is usually a closely guarded secret and can be valuable but it does not have the protections that registered IP receives.
- *Critical Partners, Suppliers, & Customers*: Strong relationships are critical to most businesses and are often one of the primary reasons for a strategic acquisition.
- *Research & Development*: R&D or innovation is the process of creating and commercializing new ideas. R&D capabilities may offer a business a short or long-term competitive advantage.
- *Brand*: Brand is often a company's most valuable and easily identified informal IP asset. A company's brand may enhance a company's reputation and differentiate it from its competitors.
- *Strategy & Market Intelligence*: Market Intelligence is a comprehensive understanding of the industry in which a business operates. Market intelligence may include specific information on competitors or new entrants or a broader approach to strategic and tactical decision-making.
- *Know-How*: Know-how can be closely-held information in the form of unpatented inventions, designs, drawings, procedures, and methods. Know-how can also be the skills and experience of a firm's employees. However, know-how held by individuals is not an asset of the company and can be lost when an employee leaves the company.

Intangible Asset Finance

Intangible asset finance, or more often described as IP finance, is almost entirely focused on the four types of formal IP: patents, trademarks, design rights and copyrights. Emma Bienias and Candice Cornelius from Stout, an independent advisory firm, authored an article which outlined for the following list of IP financing alternatives.

IP Backed Loans

IP backed loans operate the same as asset-backed loans on inventory, equipment or real estate. The borrower grants a security interest in the asset as collateral for the lender and the loan pays interest. The company generally borrows a percentage of the value of the IP asset and the lender assesses risk in part based on the asset's liquidation value.

While not limited to start-ups, IP backed loans are useful for earlier-stage asset-light businesses because these businesses often lack the tangible assets or cash flow to support a traditional credit solution. IP backed loans also allow a company to generate cash without dilution, but they are often higher-cost and may have operational or financial constraints due to covenants and other credit restrictions.

IP Royalty Securitization

IP royalty securitization can take on differing structures but generally, a securitization requires that an IP owner sell an IP-related income stream for a fixed duration in exchange for cash payment. The primary difference between a securitization and an IP-backed loan is that the IP owner is not borrowing money but is instead selling a stream of future cash flows that would have otherwise gone to the IP owner. One other notable difference between a royalty securitization and an IP-backed loan is that the repayment obligation is generally attached only to the IP asset rather than the IP owner directly, which allows the original owner to separate the repayment risk from the broader business.

For most securitization, the IP holder transfers the IP assets to a special purpose vehicle ("SPV") in exchange for a cash payment and a continuing right to use the IP. Future earnings generated by the IP assets flow to the SPV and on to the lenders. Under this structure, the original IP owner is no longer the legal owner of the IP assets. This can be favorable for the lender to the SPV because the assets are protected from creditors in the event the original IP owner files for bankruptcy.

IP Sale-leaseback

An IP sale-leaseback or license-back financing is similar to a real estate sale-leaseback where there is an ownership change and the seller pays a lease, license or fee, depending on the agreement type, to use the asset. More specifically, the IP assets are purchased by an investor and the investor enters into a contract to provide the seller use of or access to the assets for an agreed upon amount for a specific period of time.

Most IP sale-leaseback or license-back transaction have a purchase option allowing the seller an option to buy back the ownership during or at the end of the contract period. The repurchase option may have a fixed price, or it may require a fair market value appraisal at the time of repurchase. The investor may also structure the agreement so that the investor may pursue additional value through the monetization of the asset from third parties.

IP Collateral Enhancement

IP collateral enhancement is the use of insurance or guarantees on the value of the IP for the benefit of the lender to reduce credit and foreclosure risk. IP collateral enhancement improves the overall credit profile of the transaction which may allow lower interest rates and increased leverage for the borrower.

Advantages & Disadvantages of Intangible Asset Finance

The finance and monetization of IP assets have a number of advantages and disadvantages for companies seeking capital, as outlined in the previously mentioned Stout article.

Advantages

- IP finance offers an increasing number of credit alternatives for borrowers, particularly for asset-light businesses.
- IP finance can increase an owner's return through additional leverage.
- Capital received through IP finance can then be invested in projects that are expected to have a higher return than the cost of financing.
- IP finance may provide capital that might not otherwise be available or would cause dilution to existing owners.
- A company may lower its cost of capital if it's more attractive to finance the IP assets rather than the creditworthiness of the borrower.
- An IP financing may help some businesses lower their risk profile if the IP's performance is moved out of the business and isolated from a bankruptcy proceeding.

Disadvantages

- If the IP is the company's primary asset and pledged as collateral, a default on the loan could result in the loss of the IP and a liquidation of the company.
- The valuation of intangible assets is generally more difficult than for tangible assets resulting in a more complex and possibly higher risk transaction for both borrower and capital provider.
- Tangible assets are often easier to liquidate than IP as the pool of potential buyers is smaller.

- IP finance is still evolving and with a limited number of lenders who are comfortable extending capital, it can be a more expensive alternative than traditional financing options.
- For an asset to have value, it must be able to be discretely identified and for certain IP assets, specifically informal IP, there may be difficulty in meeting this requirement.

The Future of Intangible Asset Finance

Intangible assets account for trillions of dollars in value in the U.S. economy and as a result, billions of dollars have been injected into IP finance in one form or another. As the value of IP becomes more widely recognized and IP monetization techniques become more effective and sophisticated, advisors should expect IP finance to comprise a larger part of the debt capital markets.

It's critical that both business owners and their advisors understand not only where intangible asset value is found, but also how to access it. An effective IP financing can be a competitive advantage, a tool for growth or simply for wealth diversification.

In my next article, I will discuss innovation in informal IP finance and provide a list of IP advisors and capital provider. Please reach out to me at mhagen@leewardcapitalmgt.com with any questions or suggestions on these or other topics related to intangible asset finance in the modern service economy.

About Leeward Capital Management, LLC: Leeward is a specialty finance business located in Dallas, Texas. Leeward's Sale-to-Service ("S2S") investment structure monetizes the know-how found in a company's mission-critical systems, processes or data. Leeward provides capital between $10 and $100M for liquidity events, management & shareholder buyouts, family ownership transitions, independent sponsor transactions, M&A and growth. Leeward is focused on businesses in Financial & Healthcare Services, Media & Telecom, Transportation & Logistics, and E-commerce & Digital Marketing but companies with mission-critical systems and data can be found in all sectors.

About Matthew Hagen: Matt's fifteen-year tenure as the CEO of a large data and technology-enabled logistics business led him to recognize the untapped value of a company's systems, processes, and data. Matt implemented the first Sales-to-Service transaction for his family's logistics business, American Forest Products, and started Leeward to deliver a similar capital solution for other closely held businesses. Matthew received a BA and BS from the University of Southern California and an MBA from Harvard Business School and has been a member of the Young Presidents Organization for over 16 years.