Intellectual
Property
Office

Banking on IP?

The role of intellectual property and intangible assets in facilitating business finance

Executive summary

Research commissioned by the Intellectual Property Office, and carried out by:

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This is an independent report commissioned by the Intellectual Property Office (IPO). Findings and opinions are those of the researchers, not necessarily the views of the IPO or the Government.

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Purpose

Small and Medium sized Enterprises, or SMEs, are the lifeblood of the UK economy. Their ability to grow is a key determinant of the nation's future economic health. In recent years, businesses of all sizes have been investing more in intangible assets, in particular Intellectual Property (IP), than in fixed or physical assets. This study sought to examine how effectively SMEs are able to use these assets to secure the finance they need for company growth.

IP: an under-appreciated asset class

Company cash flow, perhaps the chief consideration in debt finance, is often closely connected to company IP assets. Despite this, and good evidence to show that high growth, IP-rich businesses are more resilient and perform better than others over time, the IP and intangibles which equity investors value highly are rarely considered in mainstream lending practice. This is unsurprising: balance sheets do not represent their value, and current regulations actively work against consideration of IP as an asset class but the result is a real and important disconnect between banking regulation and practice and the UK's ambition for growth.

Recent banking initiatives targeting growth businesses are finding that traditional fixed assets simply no longer exist. In the asset based lending market, too, many examples have emerged of transactions where control over intangibles is recognised as being important.

IP and intangibles are, in effect, unbankable. Change seems inevitable: how can it be accelerated?

Key Recommendations

The key recommendations of the report include the design and assembly of a resource toolkit and supporting services. When integrated, these will:

- help old and new economy businesses identify and communicate their IP and its relationship to cash flows
- help companies and lenders understand the business value of IP
- improve efficiency in due diligence on IP assets
- improve practice in obtaining reasonable and effective charges over IP
- make room for development of more effective IP markets, supported by a better information infrastructure
- enable risk to be reduced through insurance and other mechanisms

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Executive Summary

Small and Medium-sized Enterprises, or SMEs, are the lifeblood of the UK economy. Their ability to grow is a key determinant of the nation's future economic health. In recent years, businesses of all sizes have been investing more in intangible assets, in particular Intellectual Property (IP), than in fixed or physical assets. This study sought to examine how effectively SMEs are able to use these assets in securing the finance they need for company growth.

Knowledge assets aren't appreciated in mainstream UK lending

Cash flow, perhaps the chief consideration in debt finance, is often closely connected to a company's IP and intangibles. Despite this, and good evidence to show that high growth, IP-rich businesses are more resilient and perform better than others over time, IP and intangibles are rarely considered in mainstream lending practice.

This is unsurprising. Balance sheets do not represent the value of these assets, and current regulations actively work against consideration of IP and intangibles as an asset class. The result is a real and important disconnect between banking regulation and practice and the UK's growth ambitions.

Recent banking initiatives targeting growth businesses are finding that traditional fixed assets simply no longer exist. In the asset-based lending market, too, many examples have emerged of transactions where control over intangibles is recognised as being important.

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Other countries are already beginning to make change happen…

There are plenty of examples of faster growing economies taking steps to understand this issue and make knowledge assets bankable. Malaysia and Singapore are introducing guarantees to facilitate IP-backed lending; Denmark and India are supporting the development of IP marketplaces; Germany has sought to articulate the 'Wissensbilanz' to assist financial analysis of individual firms; Brazilian banks are experimenting with IP audits prior to lending.

China has publicly set out its policies to make the country a world leader in technology by 2050 which has included the establishment of targets for the creation of "indigenous IPR", while neighbouring Hong Kong set up an Innovation and Technology Fund targeting IP-rich businesses with a $5bn injection as long ago as 1999.

… and in the UK, some funders are already making the IP link

IP and intangibles represent part of the 'skin in the game' for SME owners and managers, who have often expended significant time and money on their creation, development and protection. When equity investors (from business angels to venture capital companies) assess the quality and attractiveness of investment opportunities, they invariably include consideration of the underlying IP. They want to understand the extent to which it represents a barrier to entry, creates freedom to operate, and meets a real market need.

Certain types of lending such as venture debt and pension-led funding (which directly harnesses IP assets) also involve close scrutiny of the whole asset portfolio. So why are other routes to finance reluctant to look at IP and intangibles?

Where it remains hidden and unaddressed, IP is a risk…

Taking appropriate controls over a company's registered IP in a lending scenario would involve taking a fixed charge and recording it properly at Companies House and (in the case of registered IP) on the appropriate register. As data compiled for this report demonstrates, this hardly ever happens.

Typically, lenders are reliant on a floating charge over IP which will crystallise in an event of default – by which time, important IP may already have 'leaked' or been disposed of, limiting the lender's recovery potential.

Whilst there are improvements needed to the practicalities (but not the rules) of registration, the basic step that is missing is a clear inventory of the IP and intangibles, without which a lender can never be certain that the assets which should be present are in fact to hand.

…especially when markets for it are imperfect

There is an underlying structural issue relating to value realisation in a distress situation, caused by the absence of mature marketplaces in which IP assets can be sold in the event of default. However, this cannot mean that the IP assets of a company in distress have no value. Rather; there is not yet the same tradition of disposal, or the same volume of transaction data, as that which has historically existed with tangible fixed assets.

The concern over value is partly intrinsic (because IP is unique rather than a commodity), and arises partly because of an assumption that if a company has failed, its IP was 'no good'. This is a non-sequitur, since equity investors have plenty of 'war stories' that illustrate great IP failing due to management failings – or chronic under-funding (which they sometimes attribute to a lack of bank support).

Global licensing activity leaves no doubt that IP is in fact an immensely valuable, highly tradable and very portable asset class. In individual cases, insolvency practitioners have no difficulty illustrating cases where IP has been central to recovery in a downside (distressed) situation. Current practice simply reflects the fact that the markets to reach potential buyers of IP are immature.In truth, lenders can never know precisely how much value will be realised at a future point in time for any given asset, because all prices are ultimately determined by market supply, business sector cycles and sentiment. IP is fundamentally no different – but because of the market's imperfections, trading is less transparent, and demand never gets properly tested. This can, and must, change.

IP is a missed opportunity

One of the most unhelpful aspects of the IP financing debate is the tendency to conflate the terms ‘technology’ and ‘IP’. There are millions of intangible business assets whose value is either not being leveraged at all, or only being leveraged inadvertently. Whilst it is true that technology and knowledge-based companies will own important IP, there are many thousands of UK businesses with IP (registered or unregistered) who would not think of themselves as being in the technology space, not least many of the UK’s globally recognised creative brands and manufacturers.

The new data sources studied for this report demonstrate that while registered rights ownership among micro enterprises is generally low (in itself not a surprise), small and medium-sized businesses have much more IP to offer. Furthermore, IP audit data makes it clear that IP is under-registered (where registration is possible) and confirms the existence of many non-registrable but value-additive assets – some covered by copyright, others not.

It is important to note that IP is not only the currency of the knowledge economy, as has often been observed, but also underpins the value of ‘old’ economy companies too. The more widely business is transacted with it, and the more visible it becomes in public accounts, the easier its value becomes to realise. This will lead to greater opportunities for lenders – and higher risks of inaction.

How will change be encouraged?

This study has interviewed finance professionals across a wide range of different sectors and disciplines. Whilst not all have provided their views ‘on the record’, most recognise and acknowledge that credit decisioning and account management can both benefit from better information on, and understanding of, IP and intangibles, even if regulations do not currently facilitate or encourage their actual business value to be harnessed independently for security purposes. A few have initiatives already under way which seek to address this particular aspect of ‘information asymmetry’.

What is clear, however, is that while specialist funds and some asset based financiers may be able to generate sufficient margins for detailed due diligence, mainstream lending needs cost-effective, standardised approaches in order to capture and process information on IP and intangibles (which is not currently being presented by SMEs). It also requires assistance to facilitate effective controls to be taken over the assets.

Initial activities may be best focused on cases where traditional security is known to be insufficient or unavailable. In these instances, it is important for a lender to capture as much as possible in its security envelope, since it does not have the comfort of ‘conventional’ assets as a fall-back. Unsecured lending in general, and applications to the Enterprise Finance Guarantee (EFG) scheme in particular, are places for banks to start gathering experience in dealing with IP and intangible assets – in the case of EFG, they can do so with a ‘safety net’.

Recommendations

The issues identified in this report represent a particular challenge for the development of the knowledge economy, but also place potentially serious constraints on the growth of companies in traditional industries. There are two overarching recommendations of this report:

- **A 'resource toolkit' must be put in place,** sponsored by the Intellectual Property Office and supported by funders, aimed at helping SMEs, lenders and other financiers to make more effective use of the value IP and intangibles represent within businesses. The points for focus are set out below. This toolkit should be accompanied by steps to secure financier commitment to trials, appropriate training/familiarisation, and measures to monitor the economic effectiveness of the support provided. These steps are important to ensure that further measures to assist in value realisation can be identified and a business case built for their implementation.

- **The programme must build on existing initiatives.** Apart from EFG, referenced above, there is already government support designed to boost lending through financial contributions to designated funds (the Business Finance Partnership). There are also helpful tax incentives to encourage investment in early stage companies (principally the Enterprise Investment Scheme) and to stimulate greater appreciation of the value in IP (the 'Patent Box'). All are useful developments which can, and should, play a greater role in raising awareness and appreciation of IP, and putting it to practical use for business innovation and growth.

It is important to emphasise that this report does not advocate changes to the legislative framework, to policy priorities, or to accounting standards. The steps required to unlock the business value of IP are pragmatic measures that build on principles and practices which exist today. However, the recommendations will need to be embraced by the market as a whole in order to achieve their transformative potential. They are as follows:

1. **IP and intangibles must be identified during the financing process.** For IP and intangibles to be given any consideration within credit decision-making, tools to identify and describe the actual assets (not merely evidence of expenditure) need to be embedded within the lending process. Businesses must use them, and lenders must understand and take note of them. This step will have the wider benefit of boosting IP awareness amongst the business community as a whole.

2. **The value of IP needs to be taken into account.** The most important step in harnessing IP value is to realise that this value is not nil, and therefore requires active consideration. Robust approaches to determine the value of intangibles exist in the same way as for tangible property and are now included alongside them within the Royal Institute of Chartered Surveyors' Red Book, regarded as a banking industry reference point.

3. **Due diligence guidelines can help to control costs.** Checks will be needed in order to create confidence that the ownership and quality of the IP and intangibles are understood, that they contribute to serviceability and cash flow (particularly in the case of debt finance), and that their maturity is in line with what it would be reasonable to expect,

given the development stage of the business. This will require templates, training and/or access to professional advice, at a cost that lending margins can support, within a turnaround time that meets business requirements.

4. **More effective charges should be part of the lending package.** Once knowledge assets are captured and verified, it becomes possible to create a proper interest over them. Legal templates and the resource toolkit will help lenders to achieve this at modest cost, firstly by providing appropriate wording for the instruments, and secondly by providing guidance on the procedures which must be followed when recording them.

5. **IP markets and IP financing could be facilitated through infrastructure improvements.** The development most likely to transform IP and intangibles as an asset class is the emergence of more transparent and accessible marketplaces where they can be traded. This is a domain where services must stand or fall on their commercial merits; however, the available infrastructure needs to support rather than impede their establishment.

   In particular, as IP and intangibles become clearly identified and are more freely licensed, bought and sold (together with or separate to the business), the systems available to register and track financial interests will need to be improved. This will require the co-operation of official registries and the establishment of administrative protocols.

6. **On-going management of IP and intangibles should also be supported.** IP does not stop being important once credit is granted. The asset class is unfamiliar, and lenders will need assistance in understanding it, monitoring it and encouraging businesses to use and protect it so that risk is reduced. There could be a role for the introduction of 'milestones' (as commonly used in equity and venture debt) and impairment tests to ensure that businesses are well informed and motivated to adopt appropriate IP management practices.

7. **Affordable risk mitigation strategies are to be encouraged.** Alongside certain guarantees, access to appropriate insurance policies to guard against unforeseen events could greatly increase banking confidence in adding further weight to IP and intangibles within the lending decision. There is private sector appetite to provide these if lenders are willing to create the demand; more detailed dialogue on the requirements of both parties is urgently required.

8. **Asset-based financing techniques should be adapted for IP and intangibles.** Recent financial upheavals have triggered something of a return to first principles in lending and a greater emphasis on assets for business finance (reflected, for example, in 'challenger' bank activity). This greater emphasis on assets needs to be extended to include IP. Alongside mainstream lending, where EFG is an obvious area of focus, asset based finance and alternative financing methods should therefore be targeted for IP-backed finance interventions; these are the parts of the finance industry most accustomed to understanding and assessing individual assets and their value.

9. **Steps to stimulate private investment need closer study.** IP rights can be well suited to securitisation (patents, trade marks, registered designs and copyright portfolios). Given the successful track record of venture debt, more work is needed to understand onshore and offshore fund appetite to support investment in IP-rich companies, working with managers that have the necessary expertise.

10. **IP demands joined-up thinking.** The Intellectual Property Office (IPO) exists "to promote innovation by providing a clear, accessible and widely understood IP system, which enables the economy and society to benefit from knowledge and ideas". It therefore has a role to play in scrutinising Government and finance industry initiatives to boost lending, to ensure that the assets produced by knowledge receive appropriate consideration. But the IPO is not the only player, and only when all involved appreciate that these assets matter will their true potential be unlocked.

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