

## Securitization of IP Royalty Streams: Assessing the Landscape

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This article assesses the current enthusiasm for structured finance as observed at a recent conference on intellectual property financing and provides a primer toward basic securitization terminology and techniques. In a later article I will review the experiences of participants in IP property finance and take note of some important transactions.

A handful of completed transactions has shown how IP royalty streams can be valued, rated and then securitized like bonds. But the jury is still out whether these transactions will become more universally pursued. What future proportion of royalty agreements will be structured as asset-backed securities? Will securitized IP assets ever become prevalent enough to bundle, repackage and resell on secondary markets?

On May 29 and 30, industry participants gathered at the Crowne Plaza in New York City for a conference entitled Advanced IP Structured Finance and organized by the World Research Group. They were there to debate whether IP should be the next asset class to be treated regularly as a structured financial product. Approximately 100 professionals attended the conference. Bankers, lawyers and accountants participated in about equal numbers. Underrepresented were technology managers who actually possess royalty streams to package and sell off. It is hoped more than a few of them are reading this article and will encourage their institutions to explore some of the financial innovations described herein.

The event was co-chaired James Malackowski of Duff and Phelps Capital Partners and Bob Loren of UCC Capital. They kicked off the conference on Thursday afternoon with a Wall Street panel. Mr. Malackowski assessed the magnitude opportunity: in 2002 intangible assets represented 87 percent of the S&P's market capitalization, up from 38 percent in 1982. Firms traded over \$100 billion in royalties in 2002, but less than 1 percent of that amount was securitized. Even the \$1 billion figure included whole company securitizations in which IP may not have been the driving force behind the transactions.

From those statistics, one may easily conclude that securitizing IP is a nascent

market. Is this because the financial techniques have not yet caught on or because there is some structural impediment for IP to become the next class of asset backed security? One theory holds that IP royalties are inherently less predictable than, for example, car loans or mortgages, which are the meat and potatoes of the securitization industry. With unpredictable cash flows, IP securities are simply too risky to underwrite. Before delving into that question, we should consider more specifically what IP securitization means, as the term is bandied about and often misconstrued.

### Securitization: An Overview

In its simplest form, securitization is the process of using the cash flows generated by an asset or pool of assets to support the issuance of debt.<sup>1</sup> A seller *capitalizes* its IP assets by assigning the IP and concomitant licenses to a third party—often through a special purpose vehicle (SPV)—and the seller simultaneously creates a bond-like instrument that may itself be financed or sold for cash. Thus, when issuing the IP-backed security, the seller swaps future royalties for a lump sum, effectively trading one asset for another on its balance sheet. This transaction may benefit the buyer, seller, and underwriter alike. If the benefits are widespread and important enough, the industry will grow.

### Seller's Benefits

From the seller's standpoint, liquidity is achieved from a pool of IP whose value otherwise may not be realized for years. Often, as in the case of start-up companies, the up front payment may be more valuable to the company's survival and operations than the future royalty stream, even when transaction fees and discount rates are factored in. The liquidity afforded by financing IP may be particularly valuable if the seller's options to raise capital are limited or if its cost of capital is prohibitively high. Furthermore, as a form of debt financing, securitized IP is non-dilutive to shareholders.<sup>2</sup>

The seller benefits further because IP financing is a form of non-recourse debt and the irrevocability of the bond sale becomes a *de facto* insurance policy for the value of future royalties.<sup>3</sup> There are at least

four scenarios in which this "insurance policy" could apply. First, there is the possibility of a licensee's defaulting on royalty payments.<sup>4</sup> Second, a patent could be invalidated, thereby releasing the licensee from fulfilling royalty obligations. Third, a patent may provide strong coverage, but the patent lays claim to technology that itself becomes obsolete, in which case the royalties could also dry up. Fourth, an aggressive infringer could cause expensive and risky litigation even if the patent and technology remain strong. In each of these instances the purchaser of the securitized IP faces economic loss. If the IP stream were not securitized, those risks would fall back upon the licensor.

Sellers may benefit further by the flexibility in carving up the royalty stream. IP securitizations can be structured in such a way that the seller retains an "equity" component of a royalty stream (*i.e.*, beyond a certain time frame or dollar amount), while the buyer participates principally in the "debt" (*i.e.*, the known or low risk components of the royalty stream). Accordingly, the utility function of buyer and seller are matched in a combination that could be seen as another kind of insurance policy inherent in the securitization process.

### Buyer's Perspective

Given the panoply of risks assumed from the seller, how could there then be any buyers of securitized IP? Obviously there is money to be made. A buyer purchases securitized IP for a lump sum equating to the discounted cash flows of future predicted royalty streams. Often the buyer's discount rate is high, like a junk bond's. The difference between the buyer's cost of capital and that discount rate equates to an arbitrage, which in certain cases may be a windfall to the buyer. Of course this depends on the buyer's borrowing (or raising) money cheaply, and by her prudently assessing the risks of royalties being paid. Assuming the buyer has done her sums correctly, she should be able to turn a profit, in the same manner as financing companies that buy pools of mortgages or car loans for less than they are worth.

Once purchased, securitized IP assets may be treated as any bond or financial

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security. First, the IP-backed assets are fungible securities and may freely trade without consent of the licensee. Also, like any financial asset, securitized IP may be pledged, leveraged and used as collateral.

On the buyer's balance sheet, securitized IP may be valued differently than a royalty receivable. Both are booked as assets, but a royalty receivable is usually valued at cost, so long as the royalty stream is not impaired. Securitized IP on the other hand, is a negotiable instrument that may be marked up or down, according to supply and demand. While a secondary market for IP assets has not yet developed, industry practitioners hope one will eventually exist.<sup>5</sup> Should a secondary market develop, a portfolio of securitized IP would likely be "marked to market" on a daily basis, just like a bond portfolio is priced. More efficient IP pricing would benefit shareholders, as the balance sheet more accurately reflects the market value of intangible assets.

Securitized IP, moreover, provides a certain degree of immunity from judgments in bankruptcy proceedings. This is because the IP backing a royalty stream is usually put into a special purpose vehicle (SPV) and sometimes located offshore. The corporation buying the securitized IP has contractual rights with the SPV generating the payment stream but not custody of the IP itself. So even in a bankruptcy, when the court assigns other assets to creditors, securitized IP may generate useful cashflow.<sup>6</sup>

Finally, a buyer may enjoy certain tax benefits according to the way the IP is capitalized. An involved treatment of IP taxation issues is too esoteric for this article, but it should be noted that securitized IP facilitates complex transactions, such as sale-leasebacks, which can further improve the buyer's after-tax cashflow.<sup>7</sup>

### Investment Banker's Role

No discussion about securitized IP is complete without considering the role of the investment banker and underwriter. In the simplest transaction, the banker serves as a placement agent matching sources of capital with the seller's royalty stream. He can also help both parties with valuation, terms, structure, and due diligence on the royalty stream.

When IP is securitized, and not just sold

off, the banker can apply more sophisticated financial methodologies. Below are some representative financial tools:

- *Pooling.* Securitized IP can be bundled, pooled, and sliced up according to risk and return profiles suitable for each investor. Royalties generated from a portfolio of patents have far less risk than just one or two royalty streams, and so a security comprised of a pool is an inherently more attractive investment. Also, as described above, securitized IP can be structured in such a way so the seller retains "equity" component of a royalty stream, while the buyer participates principally in the "debt." In fact, complex capital structures can be engineered with multiple tranches of debt and equity.

- *Rating.* Securitized IP may be rated like a bond by a rating agency. For example, both Moody's and S&P have active groups assessing asset-backed securities including IP.

- *Wrapping.* The returns on securitized IP may be enhanced by financial insurance (sometimes called a bond wrapper). This can make returns safe enough for certain classes of institutional investors that would otherwise view securitized IP as too risky.

- *Secondary Sales.* Finally, there is the prospect of reselling securitized IP on a secondary market. Currently there are several impediments. There is not yet enough volume for IP-backed assets to be liquid or regularly traded. Securitized IP does not conform to a regular structure so that it can be priced reliably. Finally, the SPV's behind securitized IP are too customized in each transaction for most secondary buyers to be comfortable with the cash flows. Nevertheless, the same reservations could be asserted against credit card receivables and mortgage-backed securities 20 years ago. Today there is a robust secondary market in each of those asset classes.

### Conclusions and Prospects

This article has merely scratched the surface on some of the techniques to package IP as an asset-backed security. Securitization of IP provides benefits to buyer and seller alike, and the benefits are more authentic than mere accounting treatment. The industry is still very young, and for various reasons not all practitioners are convinced IP will be securitized as regularly as other asset classes. In a subsequent

article I will discuss some representative transactions and identify leading actors.

### Notes

1. This particularly concise description is credited to Jay Eisbruck of Moody's Investor Service. See Bruce Berman, ed., *From Ideas to Assets: Investing Wisely in Intellectual Property* (Wiley, 2002), p. 44.

2. Conversely, equity can be highly dilutive. Venture capital and PIPE issues for IP-based companies usually occur at low valuations, because of the high discount rates applied against speculative royalty streams.

3. This observation is credited to Joseph A. Agiato, "The Basics of Financing Intellectual Property Royalties," in Berman, op.cit.

4. A notorious default recently occurred in one of the first and largest patent securitizations. The BioPharma Royalty Trust was created by Royalty Pharama AG to securitize royalties due to Yale University's treatment of HIV/Aids by licensee Bristol-Myers Squibb.

5. One impediment to the development of liquid, secondary market is the standardization of IP-backed securities. There is simply not enough good historical data to show how royalties for certain patent pools perform.

6. Bankruptcy laws are very complex and depend as much on structure and procedure. The reader is advised to consult competent counsel and not rely on this article, which is intended only to provide an overview of relevant topics.

7. One group with special expertise in establishing sale-leasebacks of IP is Ray Throckmorton's group at Taucus Inc.

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