KEY POINTS

- The UK Intellectual Property Office has published a report investigating how successfully SMEs are able to use their intangible assets, and in particular their intellectual property, to raise the finance they need for growth.
- The study includes interviews with finance professionals across a wide range of sectors, and highlights a general lack of understanding and appreciation of IP as an asset class in UK mainstream lending.
- The study stresses that the hurdles to IP being "bankable" as an asset class need to be overcome to address the current shortage of funding faced by small "IP rich" businesses, and provide the conditions for businesses to thrive in the UK.

Feature

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Banking on IP: a call for action from the UK Intellectual Property Office

The UK Intellectual Property Office has published a report, entitled "Banking on IP? The role of intellectual property and intangible assets in facilitating business finance", which offers a comprehensive insight into industry experience and perspectives towards the use of intangibles as an asset class in both mainstream and alternative lending practices. This article will explore the key findings and recommendations of the report and the emerging approaches towards banking on IP, both in the UK and internationally.

IP RICH; FUNDING POOR

Micro-businesses and Small and Medium Enterprises (SMEs) make up 99 per cent of the UK's 4.8 million businesses (*Small Businesses and the UK economy*, House of Commons Library, December 2012). Amongst these it is those at the cutting-edge of their sector, who commit more resources towards developing their intellectual property (IP) and related business intangible assets (intangibles) than investing in fixed or physical assets, that are increasingly seen as holding the most potential in terms of the UK's future economic growth. Research carried out by Nesta and Experian in 2011 suggested that high growth firms, which tend to invest heavily in intangibles, can be more resilient and perform better over time than others, despite having higher risk scores at the initial stages of their development (Presentation, *Nesta analysis of high growth firms before and during the recession compared to other firms*, Experian/pH group, February 2011).

Despite this evidence, the IP and intangibles which woo private investors, have traditionally been less influential in shaping mainstream lending decisions. This is not surprising, as intangible assets are viewed as more complex to identify and value than bricks and mortar, let alone dispose of in a distress scenario. However, in the face of the focus by SMEs on investment in intangibles, and the perceived difficulties in leveraging IP as an asset on which to secure finance, there is a chronic shortage of funding for the UK's smaller businesses. The scale of this problem was identified by the 2012 Brendon Report, which estimated that the prospective funding gap for UK businesses over the coming five years is in the region of £84bn to £191bn (*Boosting Finance Options for Business*: Department for Business, Innovation & Skills (BIS), March 2012). While the recent economic downturn has certainly not helped matters, this funding shortage is partly attributable to market failure.

The need to tackle these issues formed the impetus for the recent independent report: "Banking on IP? The role of intellectual property and intangible assets in facilitating business finance" (the Report). The Report was jointly commissioned by the UK Intellectual Property Office (IPO) and BIS in February 2013 to investigate the barriers to the use of IP for debt and equity fundraising, and identify possible solutions to realign mainstream lending practice with the UK's goals for economic growth. After interviewing numerous stakeholders and lenders across various sectors, the Report concludes that IP and intangibles are currently under-appreciated as an asset class and calls for market-wide action to accelerate change towards broader 'Banking on IP'.

WHERE ARE WE NOW?

Leveraging IP as an asset for funding is not a new or ground-breaking phenomenon. As discussed in the April 2013 edition (see "Intellectual Property – Banks Set Sights on Intangible Assets" by Simon Morris, Juan Crosby and Stuart Helmer [2013] 4 JIBFL 206), banks are increasingly looking to take security over a corporate borrower's IP to reduce the risk-weightings of their loans, and therefore their overall capital adequacy requirements under Basel III. However, there remains an undeniable tension between initiatives aimed at strengthening banks' balance sheets and those designed to encourage the flow of debt finance to smaller "riskier" businesses.

To encourage increased lending and investment in early stage, high potential SMEs, various policy initiatives have emerged in the UK over the past few years. These include:

- *The Enterprise Finance Guarantee Scheme*, under which a 75 per cent UK Government-backed guarantee is provided to lenders in respect of facilities offered to small businesses with an annual turnover of up to £41 million, who lack sufficient tangible collateral or a sufficient track record (but who would otherwise qualify as fundable by a bank according to their normal credit policies).
- *Collective Investment Schemes,* such as the Business Angel Co-Investment Fund (the Angel CoFund) in England, under which investments made by "angel" investors in high-growth SMEs are matched by the UK Government. The Angel CoFund has backed technology-focused and "IP rich" businesses, such as the event booking app Yplan and smart TV games developer PlayJam. However, the fund has also invested in ventures in the food, healthcare and green energy sectors.
- *The Enterprise Investment Scheme (EIS) and Seed EIS,* which offers income and capital gains tax relief in respect of equity invest-

ments in early-stage companies. The Seed EIS, as its name would suggest, is similar to the Enterprise Investment Scheme (EIS), but aimed at new companies that are struggling in the early stages of securing investment. The generous reliefs available under the Seed EIS in particular, have been commended as having contributed towards increased angel investment activity in businesses that are IP-rich start-ups.

The evidence gathered by the Report suggests that these initiatives provide useful vehicles for the provision of finance to businesses with good cash flow but who lack tangible assets against which security can be granted. Nonetheless, the overarching conclusion drawn by the Report is that more can and should be done to leverage IP to its full potential in both mainstream and alternative lending practices (for the benefit of lenders, borrowers and the British economy).

In addition, despite these developments, the Report stresses that the UK is lagging far behind other countries to facilitate IP-backed lending. Asian economies in particular are advancing beyond the provision of tax reliefs and guarantees, and have begun to provide dedicated finance in support of IP. The Singaporean Government for example, recently announced its plans to roll out an IP dedicated financing scheme which will, amongst other things, include the partial underwriting of the value of a companies' patent portfolio for the purposes of security. The announcement forms part of the Singaporean Government's ten year plan to position itself as the IP hub of Asia. The Singaporean Government's plans also include the innovative concept of IP securitisation, whereby payments of lump-sums will be made upfront by lenders in exchange for future royalty streams from a company's IP assets. The Malaysian Government has announced similar plans, setting aside funding of RM200 million (approximately USD65 million) to help develop an IP fund scheme, as well as a programme to create an IP evaluation model, which can be used by both lenders and borrowers to place a value on IP as an asset for the purposes of loan collateral.

Other countries have taken steps to address the difficulties inherent in the lack of a dedicated marketplace for the sale of IP assets in a distress scenario. Denmark established an IP exchange in 2007 which provides a platform for trading IP rights. In the US market, the world's first financial exchange for licensing and trading IP rights, the Intellectual Property Exchange International Inc (IPXI), announced its first offering for a Unit License Right contract, covering a portfolio of more than 600 patent assets, in June 2013.

The Report also discusses a 2010 project undertaken in Germany to address the complexities involved in identifying and evaluating intangibles as relevant factors in the assessment of a company's, and in particular a SME's, future financial performance and profitability. According to the Report, one of the main achievements of this project was the creation of a checklist which assigns indicators to intangibles, to provide guidance on the influence of intangibles on a company's success. In addition, an electronic template was developed on the back of this project, the "Wissenbilanz-Toolbox" (directly translated as the "Intellectual Capital Toolbox"), which enables small businesses to independently evaluate their know-how and other intangibles. In light of these developments internationally, the Report warns that more needs to be done to support smaller IP-rich businesses closer to home if the UK is to remain relevant and competitive on the global innovation stage.

WHERE DO WE GO FROM HERE?

The Report includes interviews with finance professionals across four categories of debt finance (being mainstream bank lending, asset finance and asset-based lending, venture debt and mezzanine-style finance, and alternative forms of debt finance including peer-to-peer lending and pension-led funding) and three categories of equity finance (namely crowd-funding, angel investment and venture capital). Unsurprisingly, IP and intangibles do not come out on top as the "asset of first choice" in the opinions given by these interviewees. Nonetheless, a high proportion of lenders interviewed in each of these sectors demonstrated a keen awareness of the value of intangibles to commercial success. There was also a general consensus amongst interviewees that these assets should be put to more effective use, either to tighten controls over investments, inform the appetite for investment, or both.

Three distinct issues were identified by interviewees in the Report as inhibiting the flow of finance to innovative SMEs on the back of their IP. These barriers are: (1) the perceived difficulties involved in identifying and evaluating IP and intangibles; (2) the taking of effective security over IP and intangibles; and (3) their disposal in the event of distress. The Report addresses each of these in turn and provides recommendations to tackle these issues.

(1) Identifying, evaluating and accounting for IP

The Report exposes a widespread lack of awareness, particularly among smaller businesses, as to what IP they actually own. This is exacerbated by the difficulties involved in identifying rights, such as copyright, for which no central registry exists. In this respect, the Report refers to the results of various "IP awareness" surveys which found that around 60 per cent of businesses are aware they have copyright (when in reality, this figure should stand at 100 per cent). The situation is not much brighter when it comes to registered rights. A separate IP audit discussed by the Report found that, on average, businesses in the UK have two trade marks they could register but haven't, and more than two-thirds of UK businesses have at least one potentially registrable design which they have not registered. Unsurprisingly, this "IP illiteracy" and the fact that SMEs are often not much better placed than lenders or investors to understand and communicate the IP and intangibles they own, is identified by the Report as a key barrier to the use of IP to raise funds. As a first step, therefore, the Report recommends providing companies with a means of identifying the assets they own and communicating this information to potential funders.

The Report also acknowledges the difficulties involved in determining an appropriate value for IP and intangibles in a funding scenario, particularly one that considers their potential value in a distress situation. In this respect, the Report discusses a number of established approaches to evaluating IP in the context of pension funds, as well as the guidelines

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on IP valuation that are now incorporated in industry sources of reference, such as the Royal Institute of Chartered Surveyors' Red Book. Nonetheless, the Report acknowledges that more needs to be done to help SMEs clearly and accurately demonstrate the value that their IP and intangibles may deliver, which departs from the way in which intangibles are traditionally treated on balance sheets, as these are generally shown as sunk costs.

(2) Taking effective controls over IP

The Report stresses that taking effective control over IP and intangible assets demands more than simply putting in place a security document. Practical steps to create and register security, as well as a pragmatic approach towards the enforcement steps that may be required in the event of default, are also essential. While investors and providers of debt in the private equity and venture capital environments tend to obtain a degree of control over IP and intangibles through covenants and voting rights, and have the added benefit of having focused their attention on these assets during due diligence exercises; in the mainstream debt finance markets, lenders are rarely in the same position.

The research undertaken by the Report found that, although the recording of security against IP is possible in the UK by way of registering an effective notice mechanism of the charge at the relevant registries (being Companies House and, in the case of registered IP, the relevant IP registries), in practice, these steps are hardly ever taken. In fact, evidence gathered for the Report discovered that only a few hundred financial interests are recorded against trade marks and patents on the UK IP register every year.

The taking of security over IP is only as valuable as the strength of the underlying IP. In acknowledgement of this fact, the Report underlines the importance of carrying out appropriate due diligence as to the protections and maintenance of the relevant IP, both at the outset and throughout the lifetime of a security agreement. To address each of these concerns, the Report proposes the introduction of a "resource tool kit", to be made available to SMEs, and include template wording for the purpose of carrying out cost-effective due diligence and drafting effective security documents. The "resource tool-kit" would also contain know-how on the recording of security instruments with the relevant registries, as well as guidance to encourage SMEs to adopt appropriate IP management practices to help them continue to protect and maintain their IP.

(3) Realising value from IP

The Report concludes that the most substantial barrier to broader use of IP and intangibles in lending practice is the practical difficulties involved in realising their value when required. This is linked to the inherently unique nature of IP to the business that created it. Whilst certain categories of IP are well suited to transfer to another entity in return for cash, others are intrinsically part of the business that created them and cannot be usefully or easily extracted. A related issue identified by the Report is the sometimes misplaced assumption that if a company fails or experiences financial difficulties, the underlying IP has failed. The writers of the Report rebut this presumption by proffering anecdotes from interviewee investors, who have experienced high quality IP failing to be successful in the marketplace due to the shortcomings of the management team behind it, rather than the IP itself.

According to the conclusions drawn by the Report, the development most likely to accelerate change towards IP and intangibles being relied on as a bankable asset class will be the arrival of more user-friendly marketplaces where these assets can be traded. In addition, the Report stresses that, as these assets become more clearly identified and are more freely traded, services for the registration and tracking of financial interests over IP will need to be made available and improved. The Report concludes that this is not a task for government to take on, but that solutions will require proactive input from official registries.

CONCLUSIONS

While the Report offers a timely insight into the very real difficulties faced by the UK's smaller businesses in raising finance on the back of their IP across a range of lending sectors, the Report itself states that it is not a proposal for legislative action, changes to accounting standards or even to policy priorities. The Report does not propose a uniform approach to the valuation of IP, nor does it propose guidelines or protocols for institutions to follow on IP evaluation. There is no set timetable for delivery of the initiatives proposed by the Report, such as the "resource tool kit", or proposals to ensure these initiatives are introduced and adopted in a systematic way. The writers of the Report conclude that legislative and policy change is not needed to "unlock the business value of IP" and that existing principles and practices can be built on to harness this potential. However, although attitudes amongst investors and financiers towards intangibles as "bankable" assets are clearly evolving, without more drastic action from government to fast-track this change, the Report's comprehensive research and proposals arguably risk being overlooked. Hopefully this will not happen. In a speech for the Alliance for Intellectual Property Conference in London last October (following publication of the Report), the UK Government's Business Secretary, Vince Cable, signaled a commitment to raising the profile of IP within mainstream lending:

> **"… Intellectual property is too important an asset to be undervalued by banks who are the main source of finance. That is why I commissioned a report to explore how we can improve SMEs' access to capital. We will look carefully at its recommendations in order to better support this country's creators and IP-rich businesses".**

Half a year later and little (if any) action appears to have been taken by the UK Government on the back of the Report to help bridge the finance gap for the UK's smaller "IP rich" businesses. However, even if imminent, giant leaps forward are unlikely; a focus on transforming attitudes towards the use of IP in fundraising and tackling widespread "IP illiteracy" amongst borrowers and lenders alike could prove influential in shaping lending decisions. Indeed, even if the various difficulties involved in relying on IP as a "bankable" asset class are not immediately overcome, the Report's findings suggest that IP will continue to play an increasingly important role in shaping SME credit decisions in the UK and beyond. ■