Intellectual Property Awareness Network

Topic Brief 18

Intellectual property, finance and the economy

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For the UK and internationally, IP and intangible asset finance has important implications for individual businesses and economic growth.

Context: the value of intellectual property for growth businesses and in the economy

Intellectual Property (IP) is now the most valuable asset class on the planet and yet the financing of IP based investments and its importance in the UK economy are not widely recognised or understood.

For the UK and internationally, IP and intangible asset finance has important implications for individual businesses and economic growth. Only by developing and adapting market based mechanisms along with risk-return based methodologies for IP and other intangibles, will it be possible to offer IP-rich businesses the financial support they need to expand their businesses and thereby improve economic growth[132].

The Hargreaves Review, *Digital Opportunity*[133], highlighted a widening gap between the amounts businesses invest in intangible vs. tangible assets. In its response to the Review IPAN[134] drew attention to the funding gap faced by SMEs in financing business growth in intangible assets and intellectual property.

For quoted companies up to 80% of the value attributed to them by the stock market is not underpinned by tangible assets and is based around intangible assets. This situation was highlighted by the European Commission and was summarised as follows in *Digital Opportunity*'s predecessor, the *Gowers Report*[135] in November 2006:

> *The increasing importance of knowledge capital is seen in its contribution to the value of firms. In 1984 the top ten firms listed on the London Stock Exchange had a combined market value of £40 billion and net assets of the same value. Advance twenty years and the asset stock of the largest firms has doubled while their market value has increased nearly ten times. The difference in value is accounted for by intangible assets: goodwill, reputation and, most importantly, knowledge capital...*

Research published in 2012 by the United States Patent and Trademark Office notes that "the entire US economy relies on some form of IP, because virtually every industry either produces or uses it"[136] The Report also values IP-intensive industries at $5.06 trillion in terms of value added – equivalent to 34.5% of GDP. For the Asian economies a WIPO supported report highlights the growing importance of IP in the Region and in China in particular[137].

132 Intellectual Property, Finance and Economic Development WIPO Ogier J.P. IPAN Finance, Business and Economic Workgroup 2016. http://www.wipo.int/wipo_magazine/en/2016/01/article_0002.html
133 http://www.ipo.gov.uk/ipreview-finalreport.pdf
134 IPAN response to UK IPO internal communication 2012.
135 http://www.hm-treasury.gov.uk/d/pbr06_gowers_report_755.pdf
136 Intellectual Property and the US Economy Economics and Statistics Administration and the United States Patent and Trademark Office 2012
137 http://www.wipo.int/export/sites/www/about-ip/en/studies/pdf/wipo_unu_07_china.pdf

However if the market for intangibles does not evolve, large quantities of capital will remain tied-up in low or negative yielding assets, currently estimated at $7 trillion of government bonds[138], while IP rich innovative companies will continue to have restricted access to capital and pay a high price for the cost capital in interest, equity and security.

UK investment In intangible assets and intellectual property

The relative value of intangible assets and intellectual property in a business means that the greater part of investment activity should now become focused on developing these assets. In 2011 the UK market sector invested £137.5bn in knowledge assets compared to £89.8bn in tangible assets[139]. Since the recession of 2008 the gap has widened with investment in tangibles falling in 2008 and subsequently not increasing[140] while intangible investment has continued to grow. Just under half (48%), £65.6bn of knowledge based investment is protected by intellectual property rights. Traditionally patents are often perceived as the classic intellectual property investment but they represent just 9% of the IPRs with the greatest being copyright at 46% followed by unregistered designs 21% and trade marks 21%, with unregistered designs making up the balance at 3%. Other IPRs including trade secrets were not included in the study so the true value of IPR investment is likely to be significantly greater.

The funding challenge

Equity investors, from early stage funding to management buyout, have a good general appreciation of intellectual assets and regard them as a key consideration when evaluating prospective deals. However, most businesses, particularly small and medium sized enterprises (SMEs), are predominantly reliant on bank lending or asset finance to raise capital[141].

Despite the fact that IP is acknowledged as a dominant business asset, and therefore a business's primary collateral, finance activities remain heavily concentrated on traditional assets, namely property, equipment, inventories or **receivables, as they** have been for decades. As a result, knowledge-intensive businesses with the greatest need for growth finance often struggle to obtain the funding they need. This is because they are unable to leverage the fruits of their investment in off-balance sheet IP and intangibles.

138 The World Economy Out of Ammo? The Economist 20/2/2016.
139 Estimating UK investment in intangible assets and Intellectual Property Rights 2014 Goodridge P, Haskel J, Wallis G
140 ONS tangible investment 2014.
141 Access to Finance 2007 and 2010, Office for National Statistics, October 2011- http://www.ons.gov.uk/ons/dcp171778_235461.pdf

Following Basel III, banks are even more aware of risk and its relationship to capital. They are seeking additional security, regardless of whether the Enterprise Finance Guarantee scheme is invoked. Without new solutions, it will be even harder for innovative companies in industries like software and digital media to obtain capital. These are precisely the type of high growth enterprise the Government is seeking to encourage.

Some general and specialist lending organisations are beginning to help businesses to develop a better understanding of IP issues, but most admit that they seldom (if ever) take IP specifically into account in everyday lending decisions.

Attractions of IP-backed financing

a. **Improved security –** at present any charge placed over a business's IP and intangibles tends to be floating rather than fixed, weakening its effect if the business gets into difficulties. Defining intellectual assets as part of a lending agreement puts a bank in a much stronger position with an administrator (the time when any security taken needs to be effective).

b. **Potential for value appreciation –** the IP assets of a well-run business will increase in value over time, whereas most of their tangible assets will reduce in value (even some commercial property now falls into this category, as current exposures demonstrate).

c. **A wider pool of assets –** lenders often face situations where existing good customers want to borrow more than established asset lending ratios will allow. The value contained within core intangible assets provides a means to lend more, but with increased security.

d. **Stronger repayment incentives –** where intangibles are core to business activity, they provide a powerful incentive for borrowers to honour their repayment commitments.

e. **Alternative to personal guarantees (PGs) –** lenders recognise the complications which arise from requesting PGs for business transactions. IP and intangibles provide an additional source of security and/or "comfort" which is directly related to the company, not an individual.

Challenges of IP-backed financing

a. **Visibility** – despite its importance, and the amount invested in it by large and small businesses, internally generated IP is seldom represented on company balance sheets. It is therefore incumbent on a company's directors to understand and explain their IP and intangibles in language a lender will understand. If awareness is lacking in either or both parties, this acts as a barrier.

b. **Better informed lending decisions** – obtaining insights into off-balance sheet assets (which generally include most, if not all, of a business's IP and intangibles) provides lenders with a more representative picture of a business's resources and value.

c. **Value attribution** – unquoted companies do not have access to a market mechanism to measure and demonstrate the intangible (off-balance sheet) value attributable to their businesses.

d. **Value realisation** – many tangible assets have a realisable disposal value, even if it is a fraction of the new (originally funded) cost. Markets for resale of IP and intangible assets exist, but are presently less formalised and offer less certainty on realisable values.

e. **Value risk** – some intangible assets, such as brands, can be subject to rapid value changes depending on the fortunes of the companies that own them (however, as noted above, tangible asset values can also be volatile, being inherently linked to supply and demand).

f. **Value understanding** – lenders need to gain confidence in managing the particular risk profiles associated with these assets. This involves familiarisation, training, and the adoption of recognised standards for intangible asset value management.

Activity in this area

IPAN is aware of initiatives within the IP landscape aimed at identifying and classifying intellectual assets with greater precision. There are established valuation methodologies for determining what these assets are worth, and there are specialist practitioners who are experienced in their use. For guidance the European Commission Expert Group has published a report on Intellectual Property Valuation[142]. Brokerage services and marketplaces to facilitate sale and purchase of IP and intangibles are also becoming available.

142 Final Report from Expert Group on Intellectual Property Valuation: European Commission 2013.

The UK government through the Business, Innovation and Skills Department and the Intellectual Property Office has commissioned research on financing innovative start-ups and SMEs and some of this research has now been reported (see below).

There are also signs that the commercial financing sector is looking to respond to the needs of knowledge-based companies:

- There have been instances where specialist lenders have entered into sale and licence-back agreements secured against IP assets, including trade marks and software copyright.
- The first transactions leveraging brand assets to address pension fund deficits have been completed. Large organisations including Philips, GKN, Costain, Diageo and TUI have adopted imaginative structures that leverage IP and/or the income streams derived from it.
- Financiers taking equity positions are also electing to take a charge over software assets, protected by escrow arrangements.

The role of Government

Leveraging IP and intangibles, already the engine of value creation for most growth businesses, can enable banks to lend more to new and existing customers with improved security.

The intangibles financing market needs more structure if innovative SMEs as a whole are to benefit. Recent initiatives in standard recognition must form the basis for Government and industry bodies to work together. This will enable maximum advantage to be leveraged from facilitating new business finance approaches in a fast changing world.

The independent report to UK government – 'Banking on IP?[143] – and the government's response[144] highlighted the challenges faced by small and medium-sized businesses when trying to manage and protect their intellectual property. Action to address this includes:

- Creating a toolkit to help SMEs, lenders and other financiers identify, understand and make more effective use of their IP;
- Making it easier for businesses to show what IP they have when looking for funding;
- Developing templates and providing advice which help banks and others understand the cash flow and business value of IP; and
- Supporting the development of more accessible and effective IP marketplaces.

143 http://www.ipo.gov.uk/ipresearch-bankingip.pdf
144 Banking on IP an active response 31 March 2014.

Market based solutions

IPAN has recently highlighted the role of the City in developing products and services to meet the finance and growth needs of the SMEs and the knowledge economy. This includes the development of finance, insurance and pension based solutions for the funding of intangible assets and intellectual property[145]. IPAN is actively involved in supporting market led solutions to the intellectual property knowledge and funding gap. It is working with insurance firms and one of its partner members ACID, has recently launched an IP insurance backed product for its membership[146].

Further reading and background material

General:

- Commons Library background note to Hargreaves Review[147]
- SME Access to External Finance – UK Department Business Innovation and Skills (BIS) Economic Paper No 16, January 2012
- Boosting Finance Options for Business[148]: BIS response to industry taskforce on alternative debt markets – March 2012
- SME access to finance schemes: measures to support small and medium-sized enterprise growth – UK government guidance – April 2013[149]

145 Ogier J. IPAN Vice Chair at Institute Chartered Accountants England and Wales : IP Competitive Advantage and M&A in the Global Market. 26th February 2015.
146 ACID IP insured February 2015 http://www.acid.uk.com
147 http://www.parliament.uk/briefing-papers/SN06430
148 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32231/12-669-boosting-finance-options-government-response.pdf
149 https://www.gov.uk/government/publications/sme-access-to-finance-schemes-measures-to-support-small-and-medium-sized-enterprise-growth

Value of intangible assets:

European Commission webpage on patent valorisation[150]

Creating a financial market for IP rights in Europe[151]

"What Ideas Are Worth: The Value of Intellectual Property" [152] : Kevin A. Hassett and Robert J. Shapiro, Sonecon llc, 2011

Valuation and Exploitation of Intellectual Property and Intangible Assets[153] – John Sykes Kelvin King 2003

IPAN Finance and Economics Group's submission to UK Review of Intellectual Property and Growth

"Disrupted innovation – financing small innovative firms in the UK" – independent report from the Big Innovation Centre – September 2013[154]

"Banking on IP" – independent report commissioned by the Intellectual Property Office – October 2013[155]

150 http://ec.europa.eu/growth/industry/intellectual-property/
151 http://ec.europa.eu/growth/industry/innovation/
152 http://www.sonecon.com/docs/studies/Value_of_Intellectual_Capital_in_American_Economy.pdf
153 Valuation and Exploitation of Intellectual Property and Intangible Assets John Sykes and Kelvin King 2003 ISBN 1-85811-281-8
154 https://www.google.com/search?client=safari&rls=en&q=Disrupted+innovation+-+financing+small+innovative+firms+in+the+UK+Big+innovation+centre&ie=UTF-8&oe=UTF-8
155 http://www.ipo.gov.uk/ipresearch-bankingip.pdf