INTELECTUAL PROPERTY ASSETS – FINANCING OPPORTUNITIES FOR SMES?

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Abstract: In a competitive market the use and protection of the intellectual property (IP) assets could be one of the key determinants for success and development. An increasing share of the market value of innovative small and medium-sized enterprises (SMEs) appears to be derived from their intellectual assets. Therefore, firms need to manage these assets more actively in order to identify additional ways of extracting value from them. In that sense, it is important to examine current practices of financial institutions, venture capitals, business angels regarding the IP and the extent to which IP rights can promoting exchange of best practices.

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1. INTRODUCTION

In a knowledge-based economy, intellectual assets such as intellectual property (IP), human capital and organizational skills play an essential role in ensuring business performance and economic growth.

Since no country has a monopoly on the well-springs of human imagination, the global information economy offers opportunities for sustainable development and improved standards of living (Brennan, 2009).

The re-launched Lisbon Partnership for growth and jobs placed innovation and entrepreneurship at the centre and called for decisive and more coherent action by the Community and the Member States. On this basis, an ambitious European innovation policy has been created (EC, 2007) and the Small Business Act (SBA) has been agreed (EC, 2008).

Intellectual property rights enable small and medium-sized enterprises (SMEs) to have exclusivity over the exploitation of their innovative new or original products, their creative designs and brands. Thus, the exclusivity creates an appropriate incentive for investing and improving their competitiveness.

Technology is one of the driving factors for economic growth, even it is often underfinanced. The intangibles are of a great interest to big or well established enterprises while innovative small and medium-sized enterprises (SMEs) lack internal sources of finance and have difficulties when they want to get external financing.

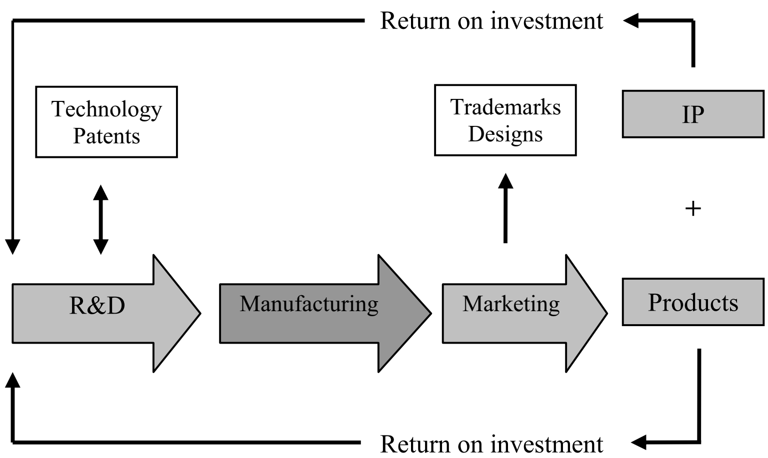
Innovative start-ups have sometimes no other assets than their intellectual property and therefore need to use it to access equity or bank loans.

Despite the fact that investors generally acknowledge the importance of IP strategy in ensuring a company's success, they are often not willing to use it as collateral for providing finance. Besides, the entrepreneurs do not always understand the commercial value of the IP assets of their enterprise and often do not understand the requirement for proper accounting.

One of the biggest challenges and the most important reward of companies in the knowledge economies consist on turning ideas and innovation into profits. In these circumstances, the valuation of many firms depends increasingly on the valuation of intellectual property. Therefore, it is critical to identify all IP assets for an SME and to make a valuation for the identified assets. In fact, understanding the economics of valuating knowledge favors the best allocation of capital and support the strategic decision making.

2. IP VALUATION METHODOLOGY

The valuation of any type of asset, including IP asset, helps its owner to decide the most cost-effective way in which that asset may be used, protected, insured, sold or exchanged in the market place. Most activities relating to planning or managing business relationships and transactions require information on the value of the IP assets of a company.



Source: European Commission, "A Memorandum on Removing Barriers for a better use of IPR by SMEs", A Report for the Directorate-General for Enterprise and Industry by an IPR Expert Group, June 2007

Figure 1. Model of IP in business

The need for proper valuation is also motivated by their expanding use in applications that extend beyond the firm (Otsuyama, 2003).

There were many ways to value IP, focused on monetary methods emphasizing that valuation methodologies must be based on a conceptual framework. Some of these methods are the followings (EC, 2006):

• *Income based* – using a multiple of historic profits or through an evaluation of the incremental profits earned (e.g. from a branded vs. a generic product). Other income-based methods include the value of excess profits over and above required rate of return, or a method based on “relief from royalty”, i.e. what a company is willing to pay for a product license;

• *Cost based* – based on the cost of reproducing the asset, which may be particularly of interest to those who wish to make a similar development;

• *Discounted cash flow* - future cash flows discounted to the present at a weighted average cost of capital. This requires projections of future income and costs (including IP protection costs), and clear assumptions or data on income;

• *Transaction based* - comparison with similar transactions in the market. The difficulty is that these are few and far between and pricing is often not very visible. With little or no public information, the transaction-based market remains an essentially private one.

The way in which IP is valued is influenced to some extent by the purpose of the valuation - financial reporting, commercial transactions such as the sale of IP or its use as collateral. Valuations can be different:

- for collateral purposes - based on what IP might realize;
- an open market sale - based on the value to the buyer;
- financial reporting - based on the lower of cost or net value.

The need for monetary valuations becomes particularly relevant when they are used as financial tools by IP holders and as investment assets by financial institutions.

The investors recognize IP as a key element in the value of a firm and as an indicator of its technological and other capabilities.

For the financial sector, the valuation of a patent is essential; the investor is interested only in highly fungible collateral. The lender is not interested in using the monopoly right; its aim is to sell it or to license it. The potential of IP assets as a possibility to secure financing is a matter of great interest among investors, particularly if supported by reliable valuation methodologies.

Valuation of intellectual property is therefore important because less knowledge about IP and even less experience in understanding the nature of IP can be considered key obstacles in access to finance. Investors and lenders expect to gain a lot from more systematic valuation of intangible capital. For the moment, the IP capital market still lacks confidence. As a result of insufficient experience of valuing intangibles, there is still little confidence on the capital market in the results of these valuations.

Investors could optimize their portfolio and increase the profits with more realistic company valuations. The credit suppliers could better lend their money on terms accordingly with the risk. Besides they could gain greater market share through better pricing, assuming they value intangible assets more efficiently and correctly than the competitors.

Enterprises often lack information about returns on investments in intangible assets. While some large companies have successfully used their IP assets to raise finance, very few SMEs have done so, mainly because of lack of awareness. Moreover, the SMEs often do not patent their know-how because the process is considered expensive and there is a risk regarding making information available to competitors. But in this case, the innovative SMEs are missing an important element of the image presented to investors as long as companies aware of their IP can better trade these assets or licences. This would create better access to equity and debt for knowledge companies.

3. HOW TO GET FINANCING THROUGH IP?

Intellectual property assets could help the SMEs taking into consideration several aspects:

- innovative SMEs will strengthen their position when obtaining business finance;
- it can give important signals about start up firms and other SMEs that often have difficulties accessing financial markets;
- it signals the technological advance and a legal protection of competitive advantage.

On the other hand, for the investors, the potential of IP assets as a source of finance is a matter of great interest, particularly if it is supported by innovative valuation methodologies. Thus, the IP assets have been used successfully to leverage capital among different financial players and new instruments of actions appeared.

Intellectual property can be used as collateral for bank loans. Companies can use their IP assets as loan collateral to prove their liquidity, value and market power. In order to use IP as collateral it is therefore important to obtain an objective valuation of the identified IP asset. Moreover, the acceptance of IP assets as collateral requires to be supported by respective national laws.

At the moment, there seem to be only few banks providing that service as many have difficulties to understand the market of intangible assets and they often take the value of the whole business as collateral.

Banks usually take into consideration the following two criteria when rating their customers' creditworthiness (EC, 2006): counterparty risk (probability of default); the loss to the bank in the event of non-repayment (loss given default).

Collateral such as real estate and plant facilities are used in the assessment and the intangibles play a minor role. There is difficulty or a reluctance to invest against an SME's future cash flow, specifically in the context when the revenue is generated by the exploitation of intellectual capital. However, an ever larger number of companies owe their success precisely to their intangible assets.

Another way to generate financial income for high growth SME is the securitization of IPs**.** The securitization of intellectual property consists on the transfer of IP by an owner to a special purpose investment vehicle for securitization and the receipt of capital from investors in the form of a lump sum payment. Typically, royalty resulted from the IP serve as the income stream to repay capital and interest to investors.

In order to be attractive to prospective investors, the securitization of IP needs to be based on a diversified portfolio of patents or other IP assets. This helps to spread risks and increases transaction size, thereby making investment worthwhile. From a SME perspective, the problems are that they usually only have a few patents and the costs are higher if it is necessary to defend a large number of patents.

Venture capital (VC) and business angel investments are another financial tool that can help innovative SME to raise capital. These investors frequently look for early-stage companies that have commercial potential, provided that adequate IP rights have been secured or can be secured to protect the underlying business.

For VC's intellectual property is not the most important asset. Venture capitals focus more on the overall evaluation of the company and the competencies of its management team and they assess the value of a patent portfolio always in relation to the business model.

Although business angels play an important role, this source of equity financing remains relatively under-developed in Europe compared with the USA.

In addition to providing early-stage finance for SMEs based on IP, the business angels can help the subsequent investments made by venture capitalists. This occurs because the business angel investment generally covers the riskiest stage in an SME's development but also because it provides a form of external validation for next stage investors.

As IP is developed, a revenue stream can be generated either from direct exploitation of the innovation or from licensing of a patent. Besides securitization, licensing is an increasingly important option and, worldwide, licensing revenues from patents have been rising sharply. However, the value of a patent is difficult to determine and depends on a combination of economic, legal, and technical considerations.

There should be taken more measures in order to attract finance for SMEs starting from the way the national, regional and local governments regard intellectual property.

The role of the public sector should concentrate on helping inventors and researchers to develop high quality IP, identifying the best possible commercialization strategies and financing the early stages of the commercialization process itself.

The European Commission and Member States should act for strengthening the "deferred contestability" principle regarding the patents. Ideally, this would protect smaller companies against litigation for a period of up to seven years.

Also, renewed consideration should be given for developing a "small" patent system. This should be designed in a way that is easy for start-ups to obtain, and which avoids the relatively high costs involved in obtaining an EPO patent. It should be introduced a system under which the costs of a patent can be deferred.

The European Commission and Member States should take steps in order to facilitate the availability of licensing guidelines and models. This includes standard forms of agreement or checklists which would help companies avoid common pitfalls.

In some EU Member States, should be introduced special purpose vehicles or trusts to protect IP assets. The advantage of this type of mechanism is that IP ownership is separated from the entrepreneur. At the same time it makes it easier for banks to provide loans and helps maintain the value of collateral.

More actions could be done to develop best practices with regard to the protection of IP, such as: the greater use of arbitration in IP disputes where there is an existing model based on the WIPO arbitration clause; another encouraging all litigation to take place in one jurisdiction to avoid multiple court proceedings (EC, 2006).

Member States should give more consideration to the role of tax reductions to encourage investment in IP-based companies. There is also a need to give consideration to fiscal policy towards licensing revenues with the aim of encouraging investors to accept more risk. These are national issues but play an important role in the supply of capital.

The World Intellectual Property Organization (WIPO) has been a recognized leader in sponsoring efforts to improve the effective management of IP assets. WIPO has an extensive program to provide assistance to states in optimizing the economic value of IP and integrating it into national development policies (Brennan, 2009). These efforts demonstrate a firm commitment to developing modern legal rules, professional practices, and management systems for the global information economy.

5. CONCLUSIONS

The increasing importance of IP in a knowledge based economy has started to change the way national, regional and local governments view intellectual property. Efforts have been made by different stakeholders to foster and promote the valuation and exploitation of patents and to encourage firms to make better use of them for improving competitiveness and European economic performance.

The public sector needs to set an adequate regulatory framework for an IP based growth strategy and can also take advantage of its role in promoting private sector initiatives. The banks and financial institutions had to become full players in the shift to a knowledge-based economy by recognizing the importance of intangible assets and developing the tools and expertise that are necessary to invest in them.

As regards extracting value from IP, the main objectives are the followings:

- develop methods in order to provide more effectively innovation capital to European companies through a more widespread understanding of intangibles as drivers of the corporate value creation process;
- investigation of new business models for investment analysis that better incorporate intangibles in order to improve the flow to capital to the businesses;
- conception, development, implementation of training programs for human skills and competencies relating to IP investment analysis;
- investigations into the demand and feasibility of methods for improving the understanding and communication of intangibles within the business reporting system.

All the activities linked to intellectual property promote conscious investment culture and help raise awareness of the value of IP among investors and borrowers.

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