

Research on Securitization of Intellectual Property for Small and Medium-Sized Enterprise Innovation

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Abstract In recent years the ongoing innovation of financial tools and asset backed security practices lead to a growing interest in intellectual property as a relevant source of funding and collateral security. Considering the new financial solutions with intellectual property as underlying asset for the corporations, this paper analyzes the potential of securitization as the proper financing strategy which the small and medium size enterprises should take during innovation and the feasibility of patent securitization operation. The governmental policies to encourage this new kind of financing mode are also suggested.

Key words Intellectual property; Securitization; SME; Technology innovation

1 Introduction

The practice of securitizing intellectual property (IP) lies within a larger trend in the changing conceptualization of corporate assets in the US. US companies are increasingly aware of their intangible assets, including intellectual property, and the need to employ valuation tools which can accurately capture their worth. As these tools have developed in methodological sophistication and gained acceptance by authorities and investors, IP securitization has expanded dramatically.

Ongoing development and innovation of financial instruments may, however, give firms easier access to financial and credit markets and more opportunities for hedging (Rajan and Zingales, 1995). This situation leads to a growing interest on intellectual property as a source of funding and collateral security. Companies with high ratios of intangible to tangible assets, frequently, have trouble in raising funds in order to manage business because they have insufficient credit-worthiness and are unable to leverage on their IP portfolio to get alternative liquidity. Given the limits and barriers to finance R&D, innovation and other activities established to build up a wide IP portfolio, the question of whether or not intellectual property could be used in order to raise funds appears to be fairly significant.

In past years an increasing number of studies has pointed out that assets related to innovation, human and organizational capital are becoming strategic for firms: the largest share of company's value resides in intangibles (Lev, 2001). Like other valuable assets, intellectual property rights can be recognized as financial assets because they give owners options on future revenue streams. Consequently, they should play an important role in companies' funding processes. However, empirical evidence shows that this outcome is yet to be achieved: characteristics of innovative firms are expected to generate a market failure in making use of traditional financial instruments (Hall, 2002).

Even if the concept to design asset backed securities drawing on intellectual property rights was born in the 90s, at the present time employment of IP asset in secured financing is quite narrow. Some authors stated that the next few years will likely see the diffusion of a new class of asset backed securities with intellectual property as underlying asset, especially patents, brands and copyrights (Edwards, 2001). According to these beliefs, market for intellectual property financing should develop significantly as a consequence of an increased awareness of intellectual property value (Hillery, 2004). However, despite their potential, IP-backed financial instruments have grown less rapidly than expected. This slow growth is related to different stakeholders' issues (Throckmorton, 2004), such as risk, IP asset valuation, demand side issues and socio-behavioral reasons.

2 Advantages of IP Securitization

2.1 For SMEs as financing method

2.1.1 Low cost of financing

A company which securitizes its IP can obtain a greater amount of revenue and a much lower interest rate than from a loan based on that future revenue. Securitization can accommodate a loan-to-value ratio of as much as 75 percent. Securitization is a good alternative to the 22 to 30 percent

rates of return demanded by mezzanine lenders

2.1.2 Unchanged ownership

Owner still retains ownership of the IP (as opposed to monetization by outright sale of IP). IP securitization can be structured so that the seller holds on to an equity component of the royalty stream, while the buyer participates mostly in the debt-side. If the SMEs acquire loans from commercial banks with IP as the mortgage, once the SMEs fail to pay the debts, their intellectual property will be auctioned by the banks and get lost, which is absolutely unacceptable for the SMEs' technology innovation.

2.1.3 Diversification of risks

The transfer process of illiquid intangible assets into liquid Asset Backed Security (ABS) reduces the risk of small and medium size enterprises and removes their unstable assets from their balance sheet, which removes their risks at the same time. Furthermore, the credit rating on the securitization can be higher than the originator's rating because of the quality of the assets, credit enhancement, and the isolation of the assets in a bankruptcy-remote entity.

2.1.4 Convenience to implement

It is very difficult for small and medium size enterprises to get loans from commercial banks without any previous credit record or make IPO on stock markets, while the securitization of intellectual property is based on the credit of intellectual properties themselves and can be securitized as long as the intellectual properties can generate steady cash flow. The capital is obtained immediately, rather than waiting for royalties to trickle in over time.

2.2 For investors

The investors who might be interested in the intellectual property backed security are primarily institutional investors, such as the pension funds or life insurance funds. They hold large amount of money in search for the proper investment portfolios which are long-term, high rate of return and highly rated. As a combined pool of financial products, the intellectual property security can largely satisfy the requirement of these institutional investors and offers them the following advantages: firstly, the IP securitization allows investment in an otherwise unavailable niche and provides the investors with unexpected rate of return; secondly, IP securitization permits investment in IP narrowly rather than in a company as a whole (the venture capitalist approach); thirdly, IP securitization has benefited underwriters, lenders, and insurers because of the payoff from involvement in an emerging asset class and it provides good coupon rate for the bond.

3 Obstacles to IP Securitization

Despite the advantages mentioned above, securitization of IP has grown less rapidly than one might expected in China. The main obstacles which are holding back IP securitization are as followed:

3.1 Cultural reasons

In SMEs which are founded in a short term, the usual condition is the accounting divisions of corporations have rarely interacted with R&D departments, where catalogues of IP are maintained. So the value of their intellectual properties is kept unexploited in the drawers of R&D departments and may miss the best timing for their securitization.

3.2 Risk and price evaluation

When the risks are difficult to gauge accurately, they are more likely to be overstated and thus an impediment to the transaction. Admittedly, the evaluation of intellectual property risk and its properly pricing require a lot of financial engineering techniques. The whole process of operation needs the cooperation of many experienced financiers.

3.3 Complexity of deal

Each IP-backed securitization is different and expensive to put together. In order to generate steady and significant cash flow, different kind of intellectual properties from different corporations should be gathered into the same asset pool and then enhance their rating. It is not easy to make the perfect IP combination to securitize.

3.4 Institution absence

The securitization of intellectual property also involves the institution construction, such as the updating of accounting principles which are related with how the SMEs should deal with the securitization of their intangible assets in their book of

accounts. The laws which may supervise the behavior of the securitization are also required to be established.

4 Governmental Policies to Support IP Securitization

Even though the advantages of securitization of intellectual properties are obvious to SMEs during their technology innovation financing and transformation process, the obstacles analyzed above has prevented the securitization process and the intangible assets in SMEs are not utilized effectively. However, there are a number of patents that are not in use. It has also been indicated that R&D investments in the SMEs do not always contribute to economic growth. In order to make China an intellectual property-based nation, owners of intellectual property including both state-owned companies and SMEs are expected to exploit such assets in their business activities to the greatest extent, and it is also necessary for the government to develop the business environment to this end.

In such light, the government should support companies in promoting the strategic exploitation of intellectual property and develop necessary environments for such exploitation of intellectual property by taking the following measures. The government will also support companies in carrying out the international standardization of activities for the purpose of increasing the value of their technologies to the maximum.

4.1 Promoting strategy emphasizing IP for SMEs

SMEs should consider intellectual property as a source of competitiveness that will produce economic benefits in the future and position it as the core of their management strategy. Some companies are taking a progressive approach to deal with business strategy, R&D strategy and intellectual property strategy all in one at their management strategy conferences. In order to promote such an approach, the government should encourage the SMEs to formulate a management strategy which focus on intellectual property exploitations.

4.2 Promoting disclosure of information on IP

It is necessary to consider an ideal disclosure system in which the securities markets would be able to properly evaluate how individual companies recognize intellectual property in connection with their business. Accordingly, the government will take measures to encourage SMEs to voluntarily disclose information on intellectual property, following the examples of environmental reporting and accounting. However, whether or not to disclose information should be decided by individual companies based on their own judgments.

4.3 Establishing a method of IP evaluation

The government will consider and organize ideas about the ideal criteria for objectively evaluating intellectual property (quantitative analysis through conversion to the amount of money or qualitative analysis), with reference to evaluating methods applied by private rating firms and according to the characteristics of each type of intellectual property. The government will also make efforts to establish a market for the assignment of patents and other intellectual property by organizing and disclosing example cases in which such property has been evaluated for mergers or acquisitions of companies, which are expected to increase in the future. In regard to the evaluation of intellectual property, the government should secure flexibility by entrusting companies with intellectual property evaluation according to their independent judgment and ideas.

4.4 Utilizing trust systems to promote the management and mobility of IP

For the purpose of promoting the consolidated management of patents and brands in the case of a business group consisting of multiple affiliated companies, services for management and distribution of patents and brands on behalf of SMEs and venture companies that own such property, and transfer of university-launched patents to private companies, the government should take necessary legislative measures with the aim of developing ideal trustees that will be able to properly undertake management business in accordance with the characteristics of individual intellectual property rights. In order to further promote securitization of intellectual property, the government may include intellectual property in the scope of subjects in trust and allow entry of general purpose companies in the trust business. Consideration should be given to ensure that sound business activities and investors' interests will not be disturbed due to abuse of rights by trustees in charge of management business.

5 Conclusion

To a number of professionals in the securities business, it seems clear that intellectual property will

be the largest asset classes in the future because it is such a great proportion of the income stream worldwide and there are benefits for both sellers and buyers. This article has discussed the potential of securitization as the proper financing strategy which the SMEs should take during innovation and the advantages and feasibility of patent securitization. The governmental policies to encourage this new kind of financing mode are also suggested. Some conclusions can be drawn from the above analysis of IP securitization:

Firstly, an effective IP strategy for a company is to perform a comprehensive assessment of its IP portfolio. Such an assessment should take into account the value of a company's patents, as well as market trends, litigation trends and the remaining life of the intellectual property asset, and its level of activity and risk. This is the first step in determining whether the company is holding any securitizable assets.

Secondly, larger and more diversified portfolios of licenses will be more attractive to investors because of the stability and predictability of expected cash flows.

Thirdly, the government should take measures to support and promote the securitization process of intellectual property so that the SMEs' technology innovation will not be held up by lack of innovation funds. The role of government in bolstering this new kind of financing for technology innovation may in great extent decide the future technology level of the nation.

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