FINANCE

BANKING ON INTELLECTUAL PROPERTY

BY ADRIAN WONG

In 1997, legendary English musician David Bowie created an unexpected milestone in the financial world by issuing 10-year bonds out of future revenues from the 25 albums in his back catalogue. This innovative approach to obtaining financing using intellectual property (IP), or "IP securitisation", netted Bowie a handsome US$55 million (RM198.6 million).

Some major corporations with substantial value in their brands decided to follow suit. In 2003, film studio DreamWorks raised US$1 billion by using the royalties from its existing and future films. And three years later, Dunkin' Brands, which owns fast-food chain Dunkin' Donuts, raised US$1.7 billion by issuing bonds backed by the royalties from its franchisees.

One would think that the success of these corporations would have sparked more exercises of this nature, but these stories have turned out to be the exception rather than the rule.

According to the World Intellectual Property Organisation (WIPO), the practice of using IP as collateral in lending is "a recent phenomenon even in developed countries". WIPO defines IP as "creations of the mind", that is, inventions, literary and artistic works, designs, symbols, names and images that are used in commerce.

The Intellectual Property Corp of Malaysia (MyIPO) regulates and promotes IP in the country. It has the distinction of being one of the first Asian IP bodies to introduce the "IP Valuation" initiative.

This initiative was launched in 2010 with the aim of creating a better understanding of monetising IP rights through IP valuation, IP financing and the creation of an IP marketplace. It was officially unveiled by Prime Minister Datuk Seri Najib Razak during the Budget 2013 announcement, reflecting the growing importance of IP in the country.

At last year's Intellectual Property Financing Conference in Kuala Lumpur, Bank Negara Malaysia deputy governor Datuk Muhammad Ibrahim made special mention of the number of Malaysian IP originations in his speech. "IP has been growing steadily [in the country]. The number of patent applications in 2013 is more than double that in 1993," he said. "For trademarks, it has more than tripled."

MyIPO statistics show that there were 2,882 patent applications in 1993. In 2013, there were 7,350 applications. Trademark applications rose to 32,225 from 10,265 during the same period.

UNPOPULAR AMONG FINANCIERS

Despite the promising numbers and early groundwork, IP as an acceptable form of collateral has not taken off in Malaysia. This is because local banks do not feel they need to use this approach, according to Alfred Chan, managing director and head of commercial banking at Citibank Bhd. "IP financing is a relatively new concept in the context of Malaysian banking," he says.

"The government's effort to promote IP financing is the right move, given that the global business environment is rapidly changing, as it is driven by globalisation and digitisation. [But] the success of IP financing in Malaysia depends on whether there is a need for it."

"Currently, not many Malaysian companies are in the ranks of IP creators, meaning they do not originate or innovate IP. Most of the IT companies in the country today are merely solution providers or system integrators."

A major issue for the banks is the lack of understanding of IP as an asset and how to value it. "A key challenge to accepting IP as collateral is its valuation. Many banks do not have the experience, expertise or capability to assess the viability of IP as well as its valuation as collateral," Chan says.

Enquiries made to local banks about IP-based loans yielded a common theme — "there is no framework in place".

Whether this refers to an internal or a regulatory framework is unclear. In fact, the only bank here to accept IP as collateral for a loan is Citibank Malaysia, but it declines to elaborate on how a company can go about applying for one.

Malaysia Debt Ventures Bhd (MDV), meanwhile, provides financing for companies in exchange for IP assets as collateral. MDV's RM200 million Intellectual Property Financing Scheme (IPFS) was introduced by the government in 2013 to assist the tech sector in its attempts to secure funding from financial institutions. The scheme has disbursed RM40 million in loans to 11 companies since its inception.

IP'S 'INSECURE' NATURE

IP is broadly divided into four categories — trademarks, copyright, industrial design and patents. Each category is governed by its own Act, has its own lifespan regulations and offers different rights to the IP holder. The common theme between all these types of IP, however, is their insecure nature. This "insecurity" makes it less than ideal as collateral for banks, according to Lee Tatt Boon, a senior consultant at Skrine, a Kuala Lumpur-based law firm.

"A landed property is very secure because the moment you are named the owner, that's it. And it cannot be changed," he says. "Whereas in the case of IP, the title may be reversible. For example, all these inventions may be new to you, but when you do a worldwide search, it may have already been done before, and that's where people come and challenge it and knock off your asset.

"Also, a patent can be invalidated and trademarks can be challenged, or sometimes even diluted in value. These are some of the reasons banks are not so interested in IP."

To illustrate the concept of dilution, Lee uses the example of the Mandarin Oriental chain of hotels, where another hotel may already exist using the same name but without belonging to the international hotel group.

"So, because of these possibilities, the value of the Mandarin name has gone down simply because of the existence of other hotels with the same name. This could be another reason banks are not so keen [on accepting IP as collateral]," he says.

Another worry is that in the event

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MDV's Intellectual Property Financing Scheme

Malaysia Debt Ventures Bhd's (MDV) Intellectual Property Financing Scheme (IPFS) has been up and running since 2013, and has provided RM40 million in financing to 11 companies thus far. *Unlisted & Unlimited* talks to MDV to find out more.

***Unlisted & Unlimited:* Are the IPFS loans given on a one-to-one basis, meaning with MDV as the lender and the applicant as the borrower? Or does MDV securitise the IP asset and create asset-backed securities and sell them to the public?**
MDV: Yes, it is on a one-to-one basis directly to a customer [Sdn Bhd or Bhd]. MDV does not securitise the IP asset nor create asset-backed securities and sell them to the public.

How many companies have applied for the IPFS to date? How much of the RM200 million has been disbursed? What is the usual tenure of IPFS loans?
MDV has financed 11 companies for a total amount of RM40 million through the IPFS. There are 19 new applications worth RM70.8 million, six of which are in the final phase of evaluation. Companies are qualified to enjoy the 2% government rebate and 50% guarantee provided by the government, which is administered by Credit Guarantee Corp Malaysia Bhd (CGC) if their application is approved.

Most of the companies that apply for the IPFS are from the ICT sector, which mainly involves patents and trademarks. MDV opens its IPFS application to other sectors as well, including biotechnology, green technology and other high growth sectors that have IP that can be commercialised.

The tenure of IPFS loans is five years (including a grace period of up to 12 months).

What is the usual collateral arrangement? Is it only secured by the IP asset, or is any other form of collateral required?
The IP asset is one of the security arrangements under the IPFS. Under the scheme, MDV allocates a margin of 80% from the IP value as financing. For example, if the IP value is RM10 million, then the financing shall be up to RM8 million [based on the business needs and requirements)].

What is the interest rate charged on companies that apply for the IPFS?
Between 7.5% and 9.75%.

Does MDV accept all types of IP (copyright, trademarks, patents, industrial designs)? What is the most common form of IP that MDV receives as collateral?
Yes, MDV accepts various types of IP [as approved by MyIPO based on its valuation]. The most common types are patents and trademarks.

Why did the government see the need for the IPFS? Is it because there were many entrepreneurs that needed financing and did not have any other form of collateral?
The government recognised the importance of innovation to the ecosystem of change in order for Malaysia to advance towards achieving high-income nation status. Hence, to further encourage innovation in the country, the government introduced IPFS to technopreneurs and tech companies, which would help elevate the tech sector and, in turn, generate positive growth for the economy.

The IPFS enables companies with IP rights to use them as an additional source of collateral to obtain funding and spur more investments for companies with technological capabilities, which in turn encourages innovation. The scheme helps to alleviate the difficulties faced by some technology-focused companies when seeking funding from financial institutions.

SOURCE: GRIFFITH HACK, PRICEWATERHOUSECOOPERS

VALUING INTELLECTUAL PROPERTY – COST, INCOME AND MARKET APPROACHES

TYPE OF APPROACH/ IP ASSET	INCOME APPROACH	COST APPROACH	MARKET APPROACH
Description	The best approach to valuing technology IP and brand IP. Values the subject asset as the present value of the earnings that the asset is expected to generate over its lifespan. Not suitable for early-stage technology as time-to-market and future earnings can be difficult to estimate. Methods include the relief-from-royalty method and excess earnings method.	Generally only appropriate for easily replicable IP, such as software. Usually would involve cost of acquiring the asset from a third party or cost of building the asset.	Although theoretically sound, generally not appropriate due to each intellectual property right being unique. Difficult to compare with other IP.

of a default, a bank might struggle to find a buyer for a "foreclosed" IP asset. Unlike real estate, IP could be harder to sell on the secondary market and may require specialised know-how to operate.

LEGISLATIVE HURDLES

According to Kuek Pei Yee, a partner at Skrine, legislation is also a hurdle for IP securitisation. "The Patents Act 1983 explicitly states that there is a notice on trusts that are not to be registered," she says. "This means that a charge cannot be created on patents for a collateral agreement."

When you use property as collateral, a trust is created on the asset to signify that the asset is pledged to the lender as collateral. In the case of a patent (based on the present Act), it appears that this cannot be done.

"First of all, you need to go in and take out provisions that prevent the registration of a charge," she says. "Secondly, you need to expressly put in provisions to allow [the registration]. This has been done for the Industrial Designs Act 1996 ... the amendments have been passed."

Other Acts (namely, the Patents Act 1983, the Trade Marks Act 1976 and the Copyright Act 1987) have been discussed, but things are still undecided.

According to Kuek, there is no similar provision that says a charge cannot be created in the other Acts. But neither does it say that a charge can be created. This ambiguity adds to the current state of confusion, which could be yet another hurdle financiers consider too cumbersome to explore.

'NO FRAMEWORK' AND THE VALUATION CONUNDRUM

Another major stumbling block to accepting IP as collateral is the valuation process. Not many financial institutions are equipped with the expertise of valuing intangible assets such as IP, which can produce a wide range of values. This makes it difficult to settle on a value that is agreeable to all the parties involved.

"Valuation itself is greatly subjective, what more an intangible asset?" says PricewaterhouseCoopers Capital associate director Adeline Khoo Suet Ling.

"When one looks at a valuation, so many questions come to mind. Which is the best methodology to apply? What are the appropriate cash flows generated by the asset? How long can the asset be used? Which discount rate is appropriate?"

Some valuation methods, such as the market approach, which uses comparable past transactions as a benchmark for valuation, cannot be wholly relied upon as they do not distinguish between certain factors, Khoo points out.

"What we always find challenging as valuers is finding an asset that is truly identical to another," she says. "For instance, the value of a 3G spectrum licence in India could be different from the value of a 3G spectrum licence in Malaysia. The unique characteristics of regulations, competition and demographics make valuation a complex exercise. This is possibly why the market approach is used in this case."

LAYING THE GROUNDWORK

However, even though these concerns are valid, alternatives have already been suggested to mitigate them, according to MyIPO's IP valuation and marketplace consultant Samirah Muzaffar.

"From a business standpoint, MyIPO is not pushing for IP to be a standalone collateral [in the agreement], but rather as part of a traditional collateralised asset. This reduces the risk that banks can take on because they are holding on to other assets besides IP," she says. "Even for MDV, it takes a debenture over a company's other assets as well as a corporate guarantee on top of the IP asset."

MyIPO has developed a national IP valuation model that is "Malaysian" in nature to suit lenders and financiers in the country. According to MyIPO's director-general Shamsiah Kamaruddin, this specifically targeted model is the first of its kind in the region.

"The IP valuation model provides a minimum for lenders and financiers to start valuing IP rights," she says. "It utilises the income approach, specifically the valuation on a relief-from-royalty basis and is generally consistent with the recommendations of internationally accepted standards such as the International Financial Reporting Standards, International Valuation Standards and International Organisation for Standardisation."

In addition to the model, MyIPO has begun training IP valuers, which are certified by the World Trade Institute, an interdisciplinary centre of the University of Bern in Switzerland. "We have engaged valuers from the US, the UK, Australia and Singapore to conduct IP valuation under the IPFS, where their valuation reports will be used in the training of local IP valuers," Samirah says.

"This is also to ensure that our valuers have a benchmark with foreign transactions and whatever valuation approach taken, it should not differ too much from previous cases."

The training of local valuers is aimed at providing Malaysian banks a cheaper alternative as foreign valuers can be costly.

According to Samirah, banks could begin by looking at loans of shorter durations to minimise risk. "Typically for IP financing, the tenure is relatively short because of the risk that technology can be obsolete. If an IP right can last for, say, 20 years, a bank can lend for three to five years and still sell the IP if the borrower defaults.

"The government will continue to make provisions to stimulate IP development in Malaysia and this ongoing IP valuation initiative, which is the first in the region, reinforces MyIPO's commitment to driving growth in the IP landscape. It is now up to the private sector players, namely the lenders, to take steps to make this initiative a success that Malaysians can be proud of." E