Intellectual Property Office

Banking on IP?

The role of Intellectual Property and Intangible Assets in facilitating business finance

Summary of a report for the Intellectual Property Office

Research commissioned by the Intellectual Property Office, and carried out by:

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Banking on IP?

Purpose

Small and Medium sized Enterprises, or SMEs, are the lifeblood of the UK economy. Their ability to grow is a key determinant of the nation's future economic health. In recent years, businesses of all sizes have been investing more in intangible assets, in particular Intellectual Property (IP), than in fixed or physical assets. This study sought to examine how effectively SMEs are able to use these assets to secure the finance they need for company growth.

IP: an under-appreciated asset class

Company cash flow, perhaps the chief consideration in debt finance, is often closely connected to company IP assets. Despite this, and good evidence to show that high growth, IP-rich businesses are more resilient and perform better than others over time, the IP and intangibles which equity investors value highly are rarely considered in mainstream lending practice. This is unsurprising: balance sheets do not represent their value, and current regulations actively work against consideration of IP as an asset class but the result is a real and important disconnect between banking regulation and practice and the UK's ambition for growth.

Recent banking initiatives targeting growth businesses are finding that traditional fixed assets simply no longer exist. In the asset based lending market, too, many examples have emerged of transactions where control over intangibles is recognised as being important.

IP and intangibles are, in effect, unbankable. Change seems inevitable: how can it be accelerated?

Key Recommendations

The key recommendations of the report include the design and assembly of a resource toolkit and supporting services. When integrated, these will:

- help old and new economy businesses identify and communicate their IP and its relationship to cash flows
- help companies and lenders understand the business value of IP
- improve efficiency in due diligence on IP assets
- improve practice in obtaining reasonable and effective charges over IP
- make room for development of more effective IP markets, supported by a better information infrastructure
- enable risk to be reduced through insurance and other mechanisms

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Background

In the UK, small and medium-sized enterprises (SMEs) on which economic recovery and growth largely depends have been investing more in intangible assets than in tangible fixed assets for a number of years. Intangibles, particularly intellectual property (IP), matter for policy owing to their role in innovation. In its recent report[1], the Big Innovation Centre summarised the position as follows:

> *Our empirical evidence reveals that intangible assets held by firms are increasing substantially, revealing the importance of knowledge in an increasingly information-based and data driven economy. Particularly, young and micro high growth firms are increasing their investment in intangible assets, and yet they are also the most likely to not be able to access funds to finance their growth.*

Whilst the difficult economic conditions of the past few years have led many companies to rein in their plans for investment and growth, the balance of evidence suggests that there remains an underlying element of market failure[2] in the financing of micro-businesses and SMEs, and that this is limiting the growth and recovery potential of the UK economy, especially given the disproportionate role high growth businesses play in economic growth as a whole[3].

This market failure has been partly attributed by BIS to *"imperfect or asymmetric information"* between finance providers and small businesses[4]. It also has a relationship to collateral or security for lending:

> *In order to overcome problems of information asymmetry, banks typically require firms to provide collateral in order to provide finance – this provides a clear problem for firms with a high proportion of intangible assets, which are unable to as easily provide any… This preferential treatment towards tangible assets in banking business models is bad for innovation, and bad for growth[5].*

There are three distinct issues with intangible assets, in particular Intellectual Property, which inhibit the flow of finance to innovative SME's. These are centred on their valuation, the taking of effective security over them and their disposal in the event of distress. These issues are discussed in more detail in the following narrative on debt and equity finance.

Manos Schizas, Senior Economic Analyst at the Association of Chartered Certified Accountants (ACCA) summarises the overall situation as follows:

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1 *Disrupted Innovation: financing small innovative firms*, Sameen & Quested, Big Innovation Centre, September 2013

2 *SME Accss to External Finance*, BIS Economics Paper no. 16, January 2012

3 *The Vital 6 Per Cent*, Nesta, October 2009

4 *SME Access to External Finance*. 'Information asymmetry' is a term used to describe a situation in which a business seeking funding knows substantially more about its situation and prospects than the funder, making screening and monitoring difficult.

5 *Disrupted Innovation*. This also references Evaluating Changes in Bank Lending to UK SMEs over 2001-12 – *Ongoing Tight Credit?*, BIS, 2013, showing that around 55% of SME term loans had collateral requirements.

The starting point is that we are increasingly moving towards an economy that generally runs on intangibles. SMEs are more reliant on these assets than most, and lack the mechanisms larger companies can use to recognise intangible values. In a larger business you will see assets present in the balance sheet that have some relationship to reputation. If you were to create a comprehensive balance sheet for an SME you would find lots of the value would be down to intangibles.

IP and related intangibles are a vitally important asset class for business value and economic growth potential[6]. Transactions across a range of contexts (many of them documented in this report) show that they can be leveraged to help overcome an absence of tangible security. However, they are often poorly understood – by businesses that own them, as well as financiers that could be benefiting from them.

The UK and international policy context

Some aspects of existing UK policy have the potential to assist companies who are largely IP-dependent to raise finance. In terms of debt, one directly relevant initiative is the Enterprise Finance Guarantee (EFG) scheme, providing a 75% guarantee on bank loans lacking collateral backing (subject to conditions and a 2% levy). Stephen Pegge, Director of SME and Corporate Communications at Lloyds, comments:

There is a bit of a tradition that EFG has been used for more marginal lending. However, it is an ideal vehicle to provide finance to people who have good cash flows but don't have tangible security.

At present EFG does not address the presence or absence of IP, but as a former senior member of the technology team at RBS and NatWest, Stuart Ager, observes:

Alignment of IP work with EFG makes sense because it could put back some of the 'skin in the game', provided that it is crucial to the business. And a valid first step would be to ensure that any problems associated with the IP are sorted out.

In terms of equity, angel co-investment schemes in England and Wales and in Scotland are having an impact, and the tax reliefs available under the Enterprise Investment Scheme (EIS) play an important role in helping investors get to grips with the risks inherent in early stage investment. As one serial investor interviewed for this report explained:

For risky start-ups, the tax breaks are an essential component to reduce investors' downside and encourage an investment.

The UK is in the process of introducing the Patent Box, allowing companies to elect to apply a 10% rate of UK corporation tax on worldwide IP profits arising from inventions covered by qualifying patents, making HMRC-approved valuations of both patents and (by default) brands visible.

6 *The Gowers Review of Intellectual Property* (HM Treasury, 2006) estimated that *"70% of a typical company's value lies in its intangible assets, up from 40% in the early 1980s"*

Other countries are moving further and/or faster than the UK. On tax reliefs, for example, during the last decade, eight other countries introduced tax reliefs of various kinds to stimulate innovation. Asian economies such as Korea, Malaysia and Singapore are now going substantially further by providing guarantees and dedicated finance in support of IP, and Brazil is experimenting with something similar. Denmark set up an IP marketplace as long ago as 2007, and China launched a strategy to encourage 'indigenous innovation' in 2008. If the UK is to compete effectively in the global innovation market, its businesses that create knowledge assets need to be able to access the finance necessary to do so.

IP and debt finance

The majority of UK SMEs who seek finance see their bank as the first port of call. The number of SME applications for credit products (827,000 during 2011-12 came under the auspices of the independent reviewer, Professor Russel Griggs[7]) strongly suggests that, if a change is to be made in recognising the value of IP, it needs to be made here.

The report looked at the significance of IP across four categories of debt finance: mainstream bank lending (overdrafts and term loans), asset finance and asset-based lending, venture debt and mezzanine-style finance and alternative forms of finance, including peer-to-peer lending and pension-led funding.

Mainstream lending

It is immediately apparent that consideration of IP and intangibles does not generally feature in the credit application process, with most banking interviewees confirming that anything recorded as an intangible asset on a company's balance sheet would have a red line drawn through it. However, since most on-balance sheet intangibles only indicate expenditure, not the presence of actual assets, this is not as unreasonable as it might seem.

Discussions with the Prudential Regulation Authority (PRA) also confirmed that while regulations do not preclude the use of IP as 'full' security, with a potentially beneficial effect on capital adequacy, such a move would require a bank to compile reliable evidence showing the losses it would expect to incur on this asset class. No lender is currently in a position to do this.

Nevertheless, if the absence of information can be overcome, the report's findings suggest that IP will play a role in informing SME credit decisions. Richard Holden is Head of Manufacturing at Lloyds:

> *Paying much attention to IP at the moment would be a big leap, but at least when it comes to understanding a company's overall position, it may provide comfort between doing something or not. It doesn't necessarily follow even at that point that lending will increase or be directly assigned to the IP, but it might make the difference between lending and not lending.*

7 *Banking Taskforce Appeals Process: Independent External Reviewer Annual Report,* 2011/2012

Peter Starmer of Barclays' credit team confirmed that in the mid-market space, IP does already get discussed as part of due diligence activities:

> *We are keen to ensure we understand how it is protected, where it is held and that it is captured effectively in our security. However, we don't consider IP as a tangible security with an attributed security value. Identifying and ensuring IP is captured in our security is more about achieving rights over the technology that drives the cash flow and making sure that it is available in the event of business distress.*

The low margins available in mainstream bank lending make it imperative that any consideration of IP can be done at modest cost. Another challenge is that IP does not presently offer the same degree of secondary exit potential as other assets. But what emerged from discussions was broad agreement that IP is important in a distress context. David Gill used to run the technology team at HSBC:

> *It is rare that the IP on its own has a value, unless you have the management team to build on it. But in distress it would be more important – the IP often ends up going back to a phoenix company, who are the ones who know how to use it.*

Asset finance and asset-based lending

Conventional asset finance is mainly concerned with helping companies finance the purchase of new plant and machinery, equipment or property. Such equipment often includes something IP-related (such as branding that contributes to value, or software to make it work), but the intangible elements *per se* are seldom considered.

Asset-based lending (ABL), where businesses borrow against the value of assets, is a more promising area for IP, despite the fact that any lending against IP and intangibles will technically be classed as an unsecured element. Neeraj Kapur is Finance Director at Secure Trust, looking to introduce new finance offerings to SMEs. He was formerly at RBS and involved with Lombard Technology Finance:

> *Increasingly, businesses are relying on IP, so you can't ignore it. I have certainly lent against software before – either software that is being sold, or software a business relies on. You either do it on the principle that the company has the money to pay you back, or you identify that you will have control if you take away the asset in the event of default. Then, if a buyer comes along, they have to deal with me instead.*

Philip White is CEO of Syscap, which has arranged a number of IP-backed deals, mainly involving software. He comments:

> *IP is almost a natural extension of what we have done in the past. If we are prepared to fund software, understand it, and recognise that it is going to make or save someone money, then funding IP is not a long walk from there.*

Christopher Hawes is director of invoice finance at RBS. Whilst his main emphasis is invoices (a particular kind of intangible asset), he says that he has often recognised cases where having a degree of control over other IP would be important, provided its value can be established:

> *There is often a tangible value to IP which can survive the death of the corporate which owns it. And when you get down to it, ABL is about lending against assets which have a value independently of the business that owns them. ABL, by its nature, lends itself to this sort of assessment.*

Venture debt and mezzanine-style finance

These forms of finance are used by companies, usually larger SMEs, with strong growth prospects that need more funding than they are able or willing to raise via equity or bank debt. Venture debt lends alongside existing equity investors, a technique which mitigates downside risk because investors generally will continue to support businesses if they get into difficulties.

Neil Pitcher of LGF Partners, formerly of Kleinworts and ETV Capital, has participated in dozens of venture debt deals. Over two cycles of activity ranging from 1999 to 2012, has seen £300m invested and only £15m provisioned. Whilst acknowledging the need for venture debt to be 'patient capital' and to have its own risk assessment and account management practices, he stresses:

> *The perception that there is no value in IP is wrong… We only lent to companies that had IP, and it was viewed as the core asset of the company, especially as it's the asset that will have driven investor behaviour.*

Some of these techniques are starting to be adopted in mainstream lending. Graeme Sands is head of growth finance at Clydesdale Bank, which has provided venture debt to a number of companies using variants of mainstream banking products:

> *Businesses are changing, from those that use physical assets to service businesses and IP-based businesses. If banks continue to look for physical assets, it follows that the lending opportunity may reduce.*
>
> *IP is not conventionally recognised by accountants and it doesn't come with a valuation certificate, but that doesn't mean its value is nil. There is value in the enterprise. The reason we believe this is due to the underlying value of the IP.*

Peer-to-peer lending and 'alternative' finance

Peer-to-peer lending is a fast-growing, highly process-oriented, data-driven activity which provides a platform individuals can use to lend to businesses directly. The largest provider is Funding Circle, which recently received support from the Business Finance Partnership (BFP), money which is now being lent directly to companies. At present, just like mainstream lending, IP is not directly considered, but co-founder Andrew Mullinger feels that the situation is changing:

There is a huge opportunity for lenders who can lend [against IP] in a smart way. I think it might be done by applying ratios to particular segments or 'slithers' across a whole portfolio, based on research into precedents where IP value has been tested, to determine what the implied IP value for that sector should be.

Alternative financing approaches such as pension-led funding have already used IP assets on many hundreds of occasions to help companies secure investment. A significant player in the SME field is Clifton Asset Management. Chairman Adam Tavener explains:

We have to be able to identify, separately value and then confirm ownership of the asset or assets. It is important to use an asset that can be valued separately from the business, as distinct from goodwill, which is about the whole business. Normally, a trade mark is used, but other assets such as databases may also have a value; quite often it might be a portfolio of different intangible assets, which attach to most businesses.

IP and equity finance

In contrast to the US, selling shares to raise business funding is a strategy only adopted by a small minority of UK companies. However, a significant proportion of high potential businesses that cannot grow without additional capital do require equity involvement at the seed stage and beyond.

The report studied IP in the context of three categories of equity finance: crowdfunding, business angel investment and venture capital. The main emphasis was on angel investment, as statistics suggest this accounts for the majority of equity funding brought to bear on UK SMEs. In equity funding, when individual investors or investment committees make a decision, it is clear that IP or intangibles that provide competitive advantage are a necessary (though not sufficient) precondition.

Crowdfunding

There has been a proliferation of crowdfunding sites. Whilst many essentially operate donation models, some offer debt finance and others equity participation. Of the equity crowdfunders for SMEs which are regulated, the largest and longest established is Crowdcube, founded by Darren Westlake. Generally speaking this type of finance works best for organisations that offer products and services which have a strong appeal to the general public, rather than more technical propositions. However IP issues can still be raised, as he explains:

Quite early on, we funded an alcoholic drinks manufacturer. One of the prospective investors pointed out that there could be an issue with a German branded drink with a similar name. That's one instance where the wisdom of the crowd helped the company address the situation before they spent lots of money building the brand.

Business angels

Since finding good quality deal flow always presents a challenge for business angels, many often identify a significant proportion of investment propositions via angel networks, which can market the (potential) availability of funds to businesses and perform a screening function. Bill Morrow founded Angels Den and has these observations on the centrality of IP to angel considerations:

> *Angels need to understand how you go about solving a problem; if I'm going to invest, I need to know what mechanism you use and whether there is something clever about it. Then, I want to find out what your unfair advantage is in the marketplace. Have you got IP?*

These views are reinforced by individual angel comments, such as the following:

> *IP is one very important aspect of barriers to entry, and the latter are critical to an understanding of whether a company has a defendable market position and can therefore exploit its know-how in a big (preferably global) market.*

> *Generally speaking, and especially with pre-revenue or very early stage businesses, the IP is the only thing you have to value with anything approaching an objective framework.*

Venture capital

Whilst the general financial climate and the resultant lack of exits have had an impact on venture capital fundraising and investor appetite, deals continue to be done, and IP is one of the areas subjected to close scrutiny where it is clear that a business has a degree of dependency on it. Mark Florman, strategic adviser to the British Venture Capital Association, comments:

> *IP is not always very high up on the checklist. It should be on there, but its importance will depend on the type of company in which the investment is being made… Where a company is more inventive or innovative, the IP is probably everything, but it may not be described as such: it may be characterised as 'technology'.*

The Business Growth Fund was established as part of the 17-point plan put forward by British Banking Association members to Government in October 2010. Funded by £2.5bn of committed capital, its role is to provide a new source of growth equity finance for SMEs. Its views on the importance of IP are expressed as follows:

> *As investors, we expect the management team to be capable of recognising the IP in the business and exploiting it. Where registered rights are an important part of the company's strategy, particularly in terms of creating barriers to entry or reinforcing a first mover advantage, then we will examine them more closely. However there are other types of intangible asset that may be more important. We are particularly interested in customer relationships and trade secrets which provide a competitive edge.*

George Whitehead of the Octopus Ventures team comments:

> *There will be some software companies where the IP is less important than the business concept, the quality of the team and the route to market; our in-house team will probably look at these. Whereas for other companies, IP is absolutely critical. In these cases, we will outsource a full strategy review including looking at the IP itself and the IP landscape to see what else is being developed and whether the company is treading on anyone's toes.*

It is interesting to note that, while 'formal' equity investors are far more likely to ask for details of IP than lenders, some of them also experience difficulties obtaining suitable information from businesses. Some angels were particularly critical about the standard of IP awareness amongst investees, and even the Business Growth Fund reports:

> *The quality of information we receive on IP is very variable - sometimes it is limited to a list of registrations. Many of the business plans we receive do not properly consider whether IP is a strategic asset. The question for us is: what is the relationship between IP and value creation?*

As well as interviewing a broad cross-section of funders, the report considers the different constraints that businesses face at different stages of development and how these relate to the 'funding escalator'. It studies a cross-section of cases where businesses with IP and intangibles, particularly those with capacity to grow, have ultimately been successful in raising finance using debt, equity or a combination of both.

It includes a summary of research conducted by Experian for Nesta in 2011[8] which demonstrated that the relationship between high growth and high risk is not straightforward. High growth firms turned out to have lower levels of insolvency despite having higher risk scores at earlier stages of their development. Combined with recently published findings from the Big Innovation Centre showing the connection between high growth and increased expenditure on intangibles, this provides additional reasons for taking IP fully into account within the decision-making and account management process.

8 Presentation, *Nesta analysis of high growth firms before and during the recession compared to other firms,* Experian/pH group, February 2011

The availability of IP and intangibles

The Intellectual Property Office recently completed a statistical exercise matching patent and trade mark ownership against the FAME database of firms registered at Companies House. While this does not allow all current rights to be matched (some are owned by individuals, and by foreign companies), it has provided some new insights into the current use of IP based on over 250,000 'live' rights.

Precise segmentation of businesses by size is made more difficult by the limitations of public accounts data. However, it is clear that IP becomes increasingly important as firms grow. Just over 2% of micro businesses found at Companies House have patents and trade marks, but this rises to more than 9% of small businesses, nearly 15% of medium businesses and almost 17% of large companies.

Business sector is predictive of registered IP ownership, with manufacturing-oriented activities at the top of the list. There is a strong showing for industries which are brand-dependent such as beverages and food products, and users of technology such as computing, optical and electronic products.

However, it is also apparent that registered IP rights are the tip of the iceberg. Previous surveys[9] have indicated that around 60% of all businesses are aware they have copyright. Analysis of the results of IPO-sponsored IP audits show that on average, businesses have two trade marks they could register, and more than two-thirds had at least one potentially registrable design. Separately, use of Inngot online audit tools suggests that almost three-quarters of companies have five or more discrete types of intangible assets within their business, and more than one-third own more than ten different types. If these are representative, companies clearly need a stronger focus on their IP and intangibles.

Realising value from IP and intangibles

As noted above, the most substantial perceived barrier to greater use of IP and intangibles is that it is hard to realise their value when needed. Whilst it is true that markets for buying and selling these assets are immature compared with those that exist (for example) for tangible fixed items of equipment, the report found plenty of evidence that substantial value is being generated and realised.

In a distress situation, the main consideration is that the IP and intangibles need to be kept together with the business. Comments from Kevan Jones, Chief Executive of the FSE Group, are representative:

> *It is not easy to dispose of IP in isolation, but it is always an important consideration in strategies to recover value. In a distress situation, it is very important to ensure that the management team is motivated and that the IP can be kept together with the know-how in the business. Often an acquirer will want to take on both the core IP and the people who know how to use it – we have had a number of cases where that is precisely what has happened.*

9 See *2006/2010 Intellectual Property Awareness Surveys,* Oxford IP Research Centre

Opinions vary on the extent to which IP can generate value outside a business, but the experiences of corporate financier Thomas Gardiner of TFF Group are instructive:

> *If you look at an asset in terms of what's sitting in a cupboard, it's not worth a lot… However, what's driving business cash flow is the fact that the IP is not in the cupboard, it's in a process or a website. In this sense, banks are actually already funding the exploitation of IP.*
>
> *What banks don't look at is what else could be done with the IP outside the business. Could it be licensed to people in other territories? …There might be a small amount of IP that is specialised and good for one business alone, but most could be used by someone else in a completely different way, and would generate additional income.*

World Bank figures on licensing obtained for the report leave little doubt about the extent to which IP and intangibles already generate external value. There are also other factors driving value generation from IP separately from business activities, including the rise of offensive and defensive patent aggregators like Intellectual Ventures, RPX and AST, and the emergence of open and closed IP auctions such as those run by ICAP Patent Brokerage.

To address liquidity concerns, insurance is another solution. At present IP insurance is a small niche market, but major players such as Aon are interested in developing new products that meet financier needs:

> *Aon's current objective is to build a series of insurance products that support the innovation process and protect the considerable investment that businesses of all sizes make in the development of new ideas whilst at the same time enabling the use of intangible assets in debt related and similar transactions where the 'value' of the IP must be guaranteed to some extent.*

Obtaining effective controls

Recourse to IP and intangibles in a downside situation will depend on whether a financier has an appropriate level of control. Evidence gathered by the report suggests this is seldom the case. The most popular method of seeking to exercise control is by way of a floating charge, which has no effect until a default scenario, by which time valuable assets may have been disposed of or compromised.

Proper identification, particularly in the case of registered IP, is the first essential step in enabling a fixed charge to be taken. However, to have an effective notice mechanism of such a charge, it needs to be recorded not only at Companies House, but also on the appropriate register at the IPO. Figures obtained for the report confirm that this hardly ever happens; only a few hundred financial interests are recorded against trade marks and patents annually.

Of course, such controls are only worthwhile if the IP itself contributes to business value and is properly protected and maintained. This argues in favour of appropriate due diligence, both at the outset and during an agreement's lifetime. The key elements which need to be considered are set out by experienced legal practitioners in the report.

Valuation and accounting

Where fixed assets are used as security, it is customary to obtain a valuation of them. Determining an appropriate value for IP and intangibles can be more complex, particularly one that takes into account potential downside scenarios, but times are changing. Even recognised banking industry sources of reference such as the Royal Institute of Chartered Surveyors' Red Book now incorporate guidelines on IP valuation.

The report sets out a number of tested approaches to IP valuation, which have undergone rigorous scrutiny in the context of pension funds. It also explains when IP and intangibles do and do not feature in company accounts – generally assets themselves will only feature directly in a post-acquisition context, and only then if the company is subject to International Financial Reporting Standards.

Conclusions: two overarching principles

The first principle concerns the 'information asymmetry' which currently exists. In the case of IP and intangibles, the problem is more profound than asymmetry, because such a term presupposes that the business seeking funding knows more than the financier. This may not be the case.

The issue that must be tackled is that in many cases, SMEs are not much better placed to understand and communicate the IP and intangibles they own than the lender or investor. This makes it harder than it should be for financiers to obtain the information they need to make an informed decision about whether any IP is valuable or fundable. It amounts to a fairly profound degree of IP 'illiteracy'.

The conclusion of this report is that a **resource toolkit** should be established, with the Intellectual Property Office acting in a sponsorship role. This must be tailored to the funding context and assembled with funder input, so that it can help SMEs, lenders and investors to make more effective use of the value IP and intangibles represent within businesses.

A toolkit is not much use if it is not used. Accordingly, it must be accompanied by steps to secure financier commitment to trials, appropriate training and familiarisation, and measures to monitor the economic effectiveness of the support provided. Given the level of interest in the subject this report has stimulated, such commitments should be possible to obtain. They are, however, vital to ensure that the toolkit is fit for purpose and that further measures to assist in value realisation are identified.

The second principle is that the programme must **build on existing initiatives.** The change needed to help companies leverage the investments they make in IP and intangibles can (indeed, must) come by inserting the necessary components into existing practices, rather than trying to create completely new financing paradigms.

To take one example: the Enterprise Finance Guarantee already seeks to tackle one of the fundamental problems facing IP-rich businesses, which is the absence of tangible security. The scheme's approach of augmenting existing established practices by addressing the risk element is logical and sensible: it simply needs to recognise and harness the assets that such businesses are in a position to bring to the table, for the benefit of both lenders and borrowers. This is a matter of requiring banks to ensure they identify value-producing IP and intangibles and place them within their security net, using the toolkit (or similar procedures).

There are other examples. The Business Finance Partnership is already providing SME support through existing channels; funds which specialise in hard-to-back business sectors such as software should be encouraged to apply. Similarly, there are already helpful tax incentives to encourage investment in early stage companies, such as the Enterprise Investment Scheme: a toolkit could work alongside those working to create deal flow, to ensure that due diligence procedures are properly conducted. There is also the Patent Box, the greatest benefit of which may prove to be that it provides all involved with a very good reason to think more seriously about IP and its visible value.

It is important to emphasise that this report *does not* advocate changes to the legislative framework, to policy priorities, or to accounting standards. Whilst it would be reasonable to argue that change could be beneficial in some areas, it is not necessary. The steps required to unlock the business value of IP are pragmatic measures that build on principles and practices that exist today.

The crucial factor is that these pragmatic steps must be adopted widely. IP and intangibles are not niche or exotic – they are mainstream assets which have simply been hidden out of sight of financiers, and in some cases businesses, for too long.

The ten recommendations

1. **IP and intangibles must be identified during the financing process**

   If IP and intangibles are to be given any consideration within credit decision-making, tools to identify and describe the actual assets (not merely evidence of expenditure) need to be embedded within the lending process. Businesses must use them, and lenders must understand and take note of them. This step will have the wider benefit of boosting IP awareness amongst the business community as a whole and will establish base data for the possible future use of IP as 'full' security.

   The first steps are to provide a means for companies to identify the assets they own, and to build information on IP and intangibles into the templates companies use when presenting information to prospective funders.

2. **The value in IP needs to be taken into account**

   Whilst immature markets mean that disposal of IP for value is not always straightforward, the most important step in harnessing IP is to acknowledge that its business value is not nil, and therefore requires active consideration within lending and investment decisions. Robust approaches to determine the value of intangibles exist in the same way as for tangible property and are now included alongside them within the Royal Institute of Chartered Surveyors' Red Book, regarded as a banking industry reference point.

The obstacle that must be addressed here is to demonstrate, reliably and repeatedly, how an SME's 'real' IP and intangibles may deliver value which bears no relation to anything that may be called an intangible on their balance sheet; this generally only shows a sunk cost.

3. **Due diligence guidelines can help to control costs**

IP and intangibles that are worth something are, by definition, unique. Because the assets are not commodities, checks will be needed to create confidence that the ownership and quality of the IP and intangibles are understood, that they contribute to cashflow (particularly in the case of debt finance), and that their maturity is in line with what it would be reasonable to expect, given the development stage of the business. These checks are unfamiliar to most lenders: investors are more practised at them, but it is clear that they too face challenges in obtaining and assessing appropriate data.

Guidelines will involve providing templates, training and/or access to professional advice at a cost lending margins can support, within a turnaround time that meets business requirements.

4. **More effective charges should be part of the lending package**

Once IP and intangibles are captured, assessed and verified, it becomes possible to create a proper and meaningful interest over them, beyond a simple floating charge. This is not happening at present; there is no real notice of these charges, leaving lenders exposed to unnecessary risk. Proper controls are an essential precondition if lenders are to place any reliance on the value inherent in IP and intangibles – which in turn benefits the borrower.

Legal templates and the resource toolkit will help lenders to achieve this at modest cost, firstly by providing appropriate wording for the instruments, and secondly by providing guidance on the procedures which must be followed when recording them to ensure their effectiveness.

5. **IP markets and IP financing could be facilitated through infrastructure improvements**

The development most likely to transform IP and intangibles as an asset class is the emergence of more transparent and accessible marketplaces where they can be traded. This is where services must stand or fall on their commercial merits; however, the available infrastructure needs to support rather than impede their establishment. A parallel lies in the way value has been added, cost reduced and enforcement activity enhanced across a range of motoring-related services by facilitating access to data held by the Driver and Vehicle Licensing Agency. As IP and intangibles become more visible and transaction volumes grow, services available to register and track financial interests will need to be improved.

This is not a job for government - but solutions will require the co-operation of official registries and the establishment of administrative protocols.

6. **On-going management of IP and intangibles should also be supported**

   IP does not stop being important once credit is granted. Despite being long established, the asset class is unfamiliar in the lending context. Businesses need to understand how to use and protect it so that risk is reduced. Financiers, too, will require assistance in motivating and monitoring appropriate activity; as examples, there could be a role for the introduction of ‘milestones’ within payment schedules (as commonly used in equity and venture debt) and periodic impairment tests.

   The proposed toolkit needs to include measures to inform and encourage SMEs to adopt appropriate IP management practices.

7. **Affordable risk mitigation strategies are to be encouraged**

   Alongside certain guarantees, access to appropriate insurance policies to guard against unforeseen events could greatly increase banking confidence in adding further weight to IP and intangibles within the lending decision. Evidence provided to this report indicates there is private sector appetite to provide these solutions, if lenders are willing to create the demand.

   More detailed dialogue on the requirements of both lenders and insurers is urgently required, to ensure that commercial sector activity is able to provide workable and affordable solutions.

8. **Asset-based finance techniques should be adapted for IP and intangibles**

   Recent financial upheavals have triggered something of a return to first principles in lending and a greater emphasis on assets for business finance (reflected, for example, in ‘challenger’ bank activity). This greater emphasis on assets needs to be extended to include IP.

   Alongside mainstream lending, where EFG is an obvious area of focus, asset-based and alternative financing methods should be prioritised for IP-backed finance interventions; these are the parts of the industry most accustomed to assessing individual assets and their value.

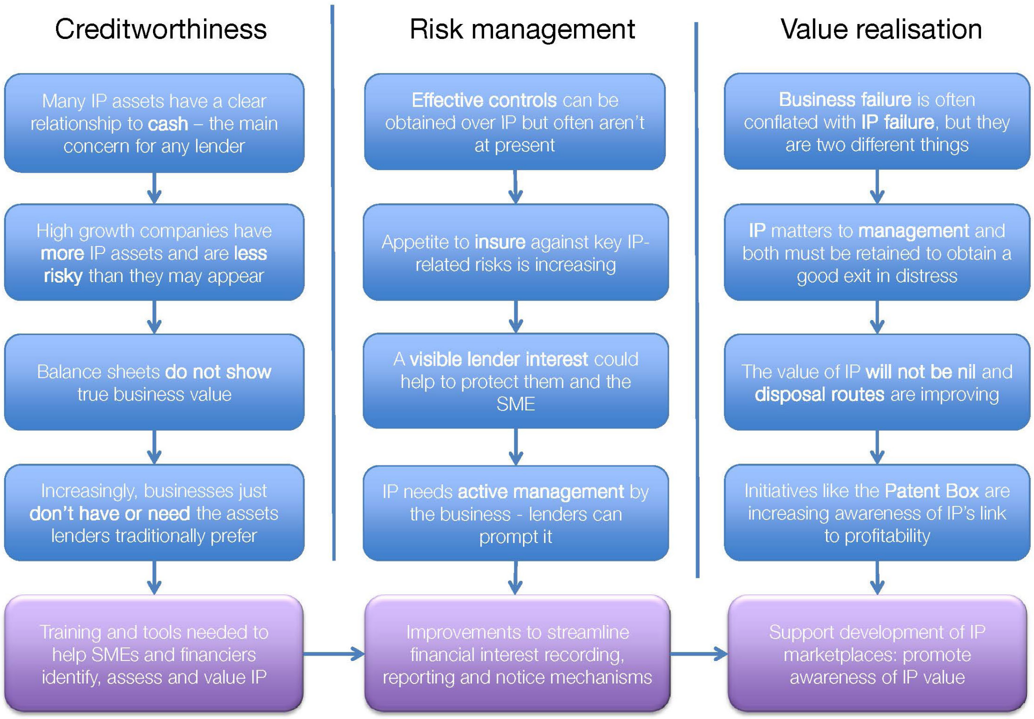
9. **Steps to stimulate private investment need closer study**

   IP rights can be well suited to securitisation (patents, trade marks, registered designs and copyright portfolios). Given the successful track record of venture debt, more work is needed to understand onshore and offshore fund appetite to support investment in IP-rich companies, working with managers that have the necessary expertise. This work fell outside the scope of the current IP and finance project, but is clearly desirable as a follow-up stage.

10. **IP demands joined-up thinking**

The Intellectual Property Office exists "to promote innovation by providing a clear, accessible and widely understood IP system, which enables the economy and society to benefit from knowledge and ideas". It therefore has an important role to play in scrutinising Government and finance industry initiatives to boost lending, to ensure that the assets produced by knowledge receive appropriate consideration.

The logic which ties together the report's findings



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