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Technical Update: Securitising intangible assets

Following EMI's recent announcement that it is considering the potential securitisation of its music catalogue, Thayne Forbes examines the process involved with securitising intangible assets.

A significant opportunity is opening up for intangible asset-rich companies in the area of debt financing. Debt financing secured on tangible assets such as receivables, property and plant and machinery has increased significantly in recent years and is now relatively common place. Securitising intangible assets, however, is less common. It has been done in a few instances, particularly in the US, but there is much more scope for growth here especially given the reduced scope for growth for lending based on other more mature asset classes. If you consider that perhaps 70% of the value of most companies is in intangible assets such as brands, copyrights and patents, this represents a considerable opportunity indeed.

There are two main benefits of securitising intangible assets. Firstly, it provides access to a greater source of capital to fund investment. Secondly, by securitising the loan the risk is reduced leading to lower interest rates and therefore cost savings. Isolating the intangible assets also has its own benefits. This delivers a greater appreciation and management of the intangible assets as their values will be continuously monitored internally as well as externally – by banks or independent advisors.

EMI recently highlighted this issue by announcing it had suspended its dividend and appointed Deutsche Bank and Royal Bank of Scotland to advise on the potential securitisation of its music publishing assets. This is a very interesting situation.

EMI has net debt of about £910m, bearing interest at varying rates but averaging about 9%. Its most recent trading update (18 April 2007) gives underlying EBITDA of £174 million (pre exceptional items, remeasurements and amortisation of music copyrights and intangibles). The most recent Annual Report (2006) describes a key resource as a deep and diverse portfolio of music recordings, comprising over 3m tracks including classics by The Beatles and The Rolling Stones and newer releases including Robbie Williams and Kylie Minogue. It also has one of the world’s largest and most extensive catalogues of music compositions with over 1 million copyrights owned, controlled or administered. Both the historic and current catalogues consistently produce recurrent cash flows year after year. This includes a solid platform of sales from "evergreen" albums, which sell consistently well over many years without significant marketing investment, amounting to 30% to 35% of EMI Music unit sales. I would estimate this is about 20%-25% of sales by value. EMI Music sales in the Annual Report 2006 were £1,660.3m and so evergreen album sales are about £370 million per annum.

Costs relating to evergreen sales are not disclosed by EMI, but given their nature they should not be that great. Assuming they are £150 million gives EBITDA of £220 million. This would indicate that the net result of all the other EMI business is a loss of £46m (to give the reported EBITDA of £174m). It should, in principle, be possible to separate and secure the evergreen albums for the purpose of raising finance and the risk of this would be lower than the combined business risk for the whole group. If interest on the loan finance, arranged in this way, was 7% that would be £64 million interest a year. This can be supported from the £220 million EBITDA per year, and would be a saving on interest of about £18 million a year from EMI’s current arrangements at around 9%. In addition other loan conditions, such as covenants, would not have to be so onerous. There is clearly big potential here for improving the terms of EMI’s debt finance in a way that would really impact profits and financing risk.

This intangible value analysis also throws a spotlight on the performance of the other EMI businesses which together show a loss of £46 million a year. This is not so apparent when the reported net off against the profits earned by the evergreen albums.

This shows that separating intangibles can give tangible business benefits. In this case there is great potential for reducing interest costs and other risks for EMI’s loans by separating and securing on its music publishing assets. It also highlights the need to address other loss making parts of the businesses. Current accounting standards do not automatically mean that this is apparent, and so the challenge for the accounting profession is to identify such situations and act on them, notwithstanding the shortcomings in reporting.

It also highlights the opportunities for banks and other financiers to offer new, more competitive, debt finance by taking advantage of the intangible assets suitable for supporting debt. EMI’s catalogue is not an isolated example where securitising intangible assets is possible. There are many characteristics which make an intangible asset suitable. The assets need to be separable from the business; the asset needs to be able to be liquidated when in distress - either through management or sale; and the asset needs to be a key driver of cash flow through the business. Examples could include the patents of pharmaceutical companies such as GSK or Sanofi-Aventis; copyrights of publishing companies such as Bloomsbury or Pearson; the brands of food and drink companies such as Cadbury’s, Bernard Matthews or Diageo; or fashion brands and retailers such as Burberry or Moss Bros. Not all intangibles are good for this, but many are.

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