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Lending against intangible assets

When times are tough recognising the hidden value in intangible assets becomes attractive. Here Stuart Whitwell of Intangible Business outlines how companies can unlock value and maximise lending. He also gives the case study of Burns Stewart Distillery.

For corporate finance lending against tangible assets is commonplace. But with tangible assets only accounting for about 20% of a company's value, what happens to the remaining 80%? Generally, this intangible value is ignored in the ABL (asset based lending) market or included as boot collateral without much appreciation of the value it contributes. Including intangible assets in the loan facility presents a considerable opportunity for businesses to borrow more money at lower interest rates and for banks to lend more money with reduced risk. Unfortunately, credit departments and corporate finance sections are not set up to deal with intangibles, restricting their ability to lend and undermining the whole asset class of intangibles which frequently supports other business assets.

When times are tough recognising the hidden value in intangible assets becomes especially attractive, which is perhaps why they are beginning to play a more significant role in bank lending. Also, intangible assets are generating more interest from administrators when previous funding arrangements go foul. The value of the intangible assets is frequently unknown and there is no strategy to realise its value. A plan, therefore, needs to be created quickly to leverage the intangible asset value.

Understanding the value of the intangible assets operated or owned by companies is essential in both these situations; at the front end - at the point of refinancing - and at the back end when it all goes wrong - at the point of default or administration.

How to value the intangible assets

Identify the assets

Identifying the assets supporting the business is the first step in the valuation. International Financial Reporting Standards (IFRS) offers the following examples of types of intangible asset classes:

1. Brand names
2. Mastheads and publishing titles
3. Computer software
4. Licences and franchises
5. Copyrights, patents and other intellectual property rights, service and operating rights
6. Recipes, formulae, models, designs and prototypes
7. Intangible assets under development

To this can also be added customer relationships, contracts and databases which, together with the above list, is a pretty comprehensive inventory of items found in many businesses. More importantly, most businesses rely on one of more of these intangible assets. Just think how much a bottle of Jack Daniel's whisky would be worth if it didn't have the Jack Daniel's name on it. Or how much value the Economist magazine would lose if it lost its database of subscribers. Or the value lost when copyright expires on books and music rights. The same rights can also be extended to particular colours such as the Tiffany Blue, smells such Crayola crayons and shapes such as the Coca-Cola bottle.

Define the assets

Isolating the intangible assets is the next step, following their identification. Sometimes it may be necessary to bundle a collection of intellectual property together as separating them is impractical. For example the Chanel No.5 smell may be so intrinsically linked to the brand name and bottle shape it is impossible to separate them so they should be valued together. The relationship between the different assets and the contribution they make to the overall business - or the value they could fetch if operated by a different owner - can now be ascertained with reasonable confidence.

Value the asset

Brand and intangible asset valuation methodologies are pretty much standardised into three different approaches. The income approach calculates the net present value of future revenue streams attributed to the assets. This generally uses the relief-from-royalty approach which determines the amount the owner is relieved from paying in royalty fees because it owns the brand or asset. The market approach compares the assets to similar market transactions, adjusted for comparability. The cost approach looks at the replacement cost and the amount spent on building the asset. In reality, each of these methodologies are considered, tailored to the specific asset in consideration.

When securitising intangible assets, specific attention needs to be given to four key areas.

1. The cash flows from the asset have to be predictable to give investors confidence in the reliability of the asset valuation.
2. The risks need to be clearly articulated and considered in the valuation
3. The valuation needs to be as if it was in a distressed situation because that is when the true test of the valuation will be required

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4. An exit strategy for realising the asset's value needs to be articulated. This includes identifying the market for the asset and the time and manner in which the asset can be managed, pending a sale perhaps, to realise its value

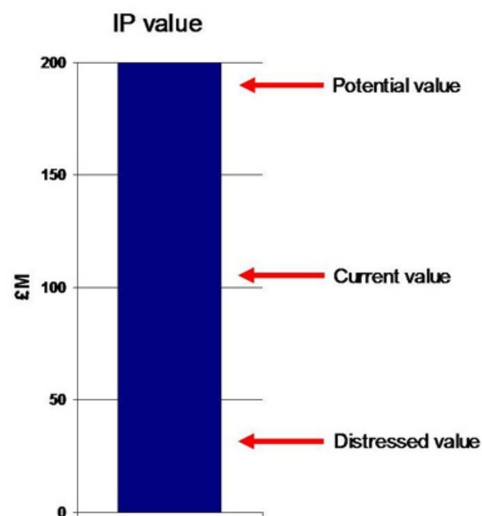
With a realistic appreciation of these issues, intellectual property can be valued to facilitate a lending facility and also to assist in the administration process.

Benefits and risks

Refinancing including intangible assets as collateral has two key benefits to businesses. Firstly, it provides access to a higher loan amount as more collateral can be offered. Secondly, as more collateral is offered - and frequently this collateral is what supports the business - the bank is reducing its risk which results in lower interest rates and therefore lower repayments for the business. Of course, this has converse risk for the business that should they default on the loan, they would lose control of a major business asset.

The bank's risk rests solely on an inability to recover the loan amount if the business fails to repay the loan. By default, both the business and the asset are at high risk of being damaged in this scenario. This scenario, however, forms the basis of the valuation and a plan to extract the value from the asset should have been identified previously. This exit strategy is the key to securitising intangible assets. It needs to be put in place to minimise any potential distress to protect the asset value. A frequent scenario is to develop a management strategy to run the business so the assets can be sold in a controlled manner, rather than in a fire sale.

The following three illustrative values would therefore be given with the value secured against being between the current value and the distressed value at the most conservative level:



There are a number of key things to look out for during this process. The most fundamental component is the valuation. Understanding the complexities of intellectual property is a specialised business so should be undertaken by an appropriate expert. The risks of not carrying out a thorough valuation could put the whole deal in jeopardy. The other main consideration is the exit plan. This generally forms part of the valuation process but special consideration should be put to it when lending against intangible assets or other assets that are supported by the intangible assets - which in many businesses is everything.

The opportunities to both businesses and investors are clear and the markets are now sophisticated enough to appreciate the value intellectual property brings to the bottom line. All that remains is for the market to start leveraging this hidden intangible value and use it to fuel growth.

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