
LENDING AGAINST INTANGIBLE ASSETS



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**LENDING AGAINST INTANGIBLE ASSETS –
THE FINAL FRONTIER**

**ASSET BASED LENDING
MARKET**

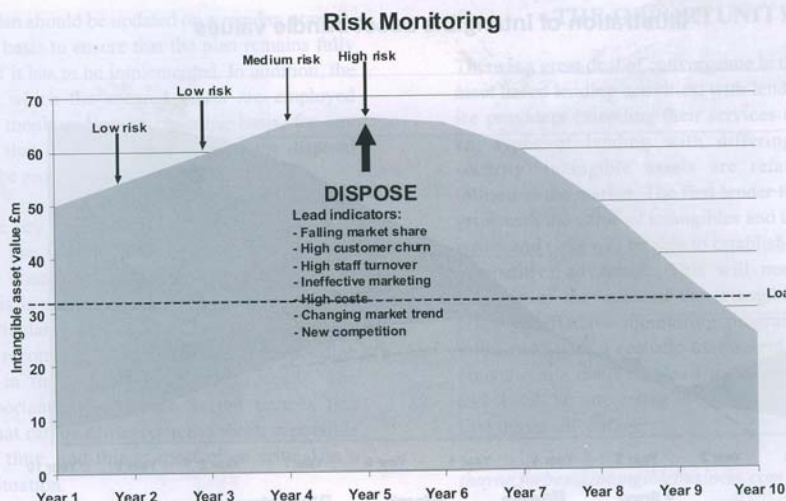
The market for asset based lending, mainly based on receivables, property, plant & machinery, and inventory, is becoming fiercely competitive. In the UK this market is now very mature, with little scope for growth and great pressures on price. Asset based lenders are therefore looking for differentiation, either in the ability to manage risk or by looking further at developing business in new asset categories. Beyond the UK, markets are developing strongly and lenders need to be aware of the full scope and potential for securing assets. The main category of under utilised assets in this context are intangible assets such as trademarks, patents, and copyright. Historically, lenders have been reluctant to lend on intangible assets largely as a result of a lack of confidence in valuation practices. Now, with proven, reliable and accepted methodologies things are beginning to change.

**TYPES OF LENDING
IN THE MARKET**

Intangible assets are being used as security for lending in the market, but this is generally as additional comfort on top of security taken on other asset classes. In addition there is some direct lending based directly on intangibles. However, without a reasonable knowledge of the value of these intangible assets and the risks associated with selling them, it is difficult for lenders to assess how much reliance can be placed for security purposes, and what measures should be put in place to monitor risk and minimise potential future problems. It is much better to have some handle on the value and what drives it, than no real information at all. This knowledge can reduce the risk of losses on realising security, illustrated by the following:

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For all assets there are issues when they are used as security for lending, such as:

1. How good is the security (eg fixed or floating charge)?
2. What is the asset value (eg £50,000 or £50,000,000)?
3. Which assets need to be bundled together to ensure the value?
4. How predictable are the cash flows?
5. What is the asset value in a distress situation and how easily can it be realised?
6. What are the key risks, and can they be foreseen and managed?
7. Is there/will there be a market for these assets and of so under what circumstances?

The importance of these issues vary with the assets, and for intangible assets they are quite specific. In overall terms these are: what is the value (and including, how subjective this is?), and how easily can it be sold and for how much in a distress situation?

These issues can be difficult to deal with, but modern intangible valuation techniques are now well established and, when well applied, give good information on which to base decisions. Such valuations have elements of subjectivity, but will give a good idea of the level of value, how subjective it is and what drives it. Also, these valuations are carried out on a number of occasions in other markets, which means that they do not have to be that expensive.

IDENTIFYING THE VALUE DRIVERS

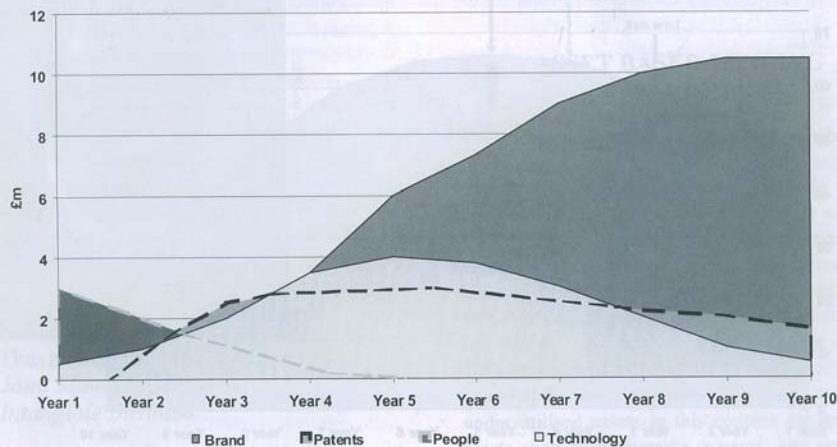
In the case of a potential sale, an intangible valuation will identify the likely buyers and their requirements thus making for a better assessment of the likely outcome under that scenario. This will vary substantially even for intangible assets, for example a trademark which is licensed to blue chip companies will be easier to sell than if it were just utilised within a business. The underlying analysis and knowledge can be used to structure ownership of the intangible assets in a way which minimises the risk of a shortfall on realising security.

Intangible asset valuation techniques can also cover the key issue of where the value lies and what drives that value. Take for example software copyright. This may not be of practical commercial value without the services of the programmers who developed the software so it is important to be aware of this. Often there are ownership issues with copyright, a notoriously difficult area. This knowledge will then guard against placing undue value on just the copyright for security purposes.

Sometimes there is a substantial bundle of different intangible rights, and their value and relative importance will change over time. It will be important to appreciate this when using these assets as security because such changes can be substantial, shown by the following:

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Illustration of intangible asset bundle values



ONGOING MONITORING

Knowledge of what drives intangible asset value can be used to monitor the lender's ongoing exposure in respect of the security given. This is a similar concept to the monitoring techniques of factoring companies relating to advances based on receivables. So a key driver of the value of a trademark could be sales of products using the mark. Sales of these products can be monitored both with historic figures and forecasts. Any issues such as declining market share should therefore be identified earlier, reducing the risk of shortfall on realising such security.

SALE IN A DISTRESS SITUATION

What happens in a distress situation will depend on the nature of the intangible assets and the potential markets in which it could be sold. Some intangible assets will be unaffected by financial difficulties of the owner, for example the Laura Ashley trademark was largely unaffected by the financial difficulties the company was in a few years ago. The trademark was deployed in completely different markets from the financial markets in London. In such circumstances we would expect the trademark to still achieve a substantial sale value.

In the example of customer relationships, it may not be possible to sell the asset separately once the com-

pany is in financial difficulties. However, if a wine merchant has a list of hundreds of thousands of consumers who have bought expensive wines in the past, that list of customers would have a value to other wine merchants and suppliers of similar products. Such a customer list is a saleable asset.

The key to maximising the achievable forced (distress) sale value, and hence the amount of the loan that it can support, is to plan for the possible sale of the asset from the inception of the loan. The lender needs to have in place a disposal plan for the asset, in the event that the borrower defaults. This plan should cover the following key points:

1. Putting in place a sales team with the necessary market knowledge and contacts to conduct the possible sale.
2. Ascertaining whether a market exists for similar assets.
3. Identification of potential purchasers for the asset and the rationale that drives their interest.
4. Identification of all other assets necessary to maximize the marketability of the assets (and securing the lender's rights to these assets).
5. A maintenance plan to ensure the continued exploitation, and protection, of the asset during the sale process.

As with all contingency planning, it is essential to keep plans under review as circumstances vary. The

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disposal plan should be updated on a regular, normally annual, basis to ensure that the plan remains fully effective if it has to be implemented. In addition, the market in which the secured assets are employed should be monitored on an on-going basis, for any indication that an immediate update of the disposal plan may be required.

One of the key outputs of disposal planning will be to advise the lender of the estimated time from default to conclusion of a disposal and receipt of funds. This is unlikely to be a fixed period of time for a particular group of assets, and we normally expect to recommend a range with a corresponding variation in the expected disposal proceeds. The most important consideration is the bottom line number that can be achieved in the shortest possible period of time, and this is most often critical in a distress situation.

THE OPPORTUNITY

There is a great deal of convergence in the market for asset based lending activities, with lenders and service providers extending their services across different types of lending with differing associated security. Intangible assets are relatively under utilised in the market. The first lender that can get to grips with the value of intangibles and the associated issues and risks will be able to establish a sustainable competitive advantage. This will need an understanding of the value of the intangibles, to put in place an effective monitoring programme to minimise risk, with a realistic assessment of the likely outcome in a distress sale. The opportunity is there and it will be interesting to see who establishes the first mover advantage.

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FACTORS DO NOT explain the increase Austria experienced in factoring volume (measured against the gross domestic product) from 1.55% in 2004 (2003: 1.3%) to 1.74% in 2005.

Factoring continues to benefit from developments based on Basel II discussions. Unlike in the past, banks now tend to be much more lenient in respect of loans secured by receivables not only because of the risks and hence the capital requirements, but also due to the costs involved in the administration of such loans, and consequently they are now more willing to cooperate with factors.

In 2005 a new law came into force of which the full impact will be felt in the next few years. After two decades of constant lobbying by the Factoring Association, an initiative brought by the Austrian Chamber of Commerce to reduce the effects of the ban of assignment finally became law. Since June 2005, a buyer's refusal to accept the assignment of a receivable will not impact upon the assignee and discharging payments have to be made to this party.

The change in legislation, which was supported by all parties represented in the Austrian Parliament, will have a stabilising and positive influence on the factoring industry in the future. However, the reaction of banks and all buyers to the new legislation remains to be seen.