Building a capital market for intangibles

Intangible assets represent an untapped source of capital for American companies and an unrecognised opportunity for investors. But creating robust capital markets for intangibles is challenging – a task made even more difficult by recent turmoil in the financial markets

By **Kenan Patrick Jarboe**

We live in an intangible-driven economy. Economists estimate that the US invests over US$1 trillion each year in creating intangible assets (see box on page XXXX). These intangibles – ranging from research and development activities to marketing, and from patents to reputation – fuel economic prosperity. Yet these investments and the wealth they create are largely hidden. They do not show up on corporate balance sheets or in economic statistics.

Companies understand the importance of intangible assets, even if they are unsure as to how to manage them. In a 2003 Accenture survey of senior managers across industries, 49% of respondents said that intangible assets are their primary focus for delivering long-term shareholder value. Yet only 5% stated that they have an organised system to track performance of these assets. A full one-third of the respondents said they had no system to measure performance whatsoever. When asked to measure the importance of managing intangible assets for long-term value, half of the respondents listed the issue in their top three most important considerations. A noteworthy 50% of respondents seemed to believe that the equity markets recognised and eventually rewarded companies that invest in intangibles.

Our economic policies and regulatory systems, public and private, are still largely set up to accommodate the tangible assets of the industrial era – buildings, fixed resources and machinery. This is not surprising; these systems have evolved over the past couple of centuries as the industrial revolution unfolded. But we need to update these systems for the new knowledge-based economy.

Hidden assets

Intangible assets only rarely show up in the financial system. US accounting standards, known as Generally Accepted Accounting Principles (GAAP), do not fully incorporate intangibles in financial statements. The Securities and Exchange Commission's (SEC) Regulation G restricts the use of non-GAAP financial measures for accounting purposes. Only those intangibles acquired from outside the firm must be accounted for separately from goodwill under GAAP – specifically the Financial Accounting Standards Board's (FASB) Statements of Financial Accounting Standards (SFAS) 141 and 142.

This is not to say that intangibles have been completely missing from both debt and equity markets. It can be argued that equity markets have long recognised the value of intangibles by valuing companies above and beyond the sum of their tangible assets. In the debt market, intangibles – specifically intellectual property – have been used as collateral for loans dating back to at least 1837 when the first trade secrets case in the United States involved debt on a bond secured in part by a secret chocolate-making process.

In more recent years, intangible assets have found their way into the securitisation process, starting in 1997 with the Pullman Group's Jones/Tintoretto (aka Bowie Bonds) deal based on the record master and music publishing royalties of rock star David Bowie. Patents, brand names and film royalties have all been utilised in one form of securitisation or another, to some extent.

The Intangible Asset Finance Society (www.iafinance.org) comprises finance, innovation and intangible asset management professionals dedicated to capturing maximum value from intellectual properties and other intangible assets, such as quality and integrity, safety, and security and resilience. IAM *magazine is the media partner of the Society. In each issue,* IAM *publishes a contribution from the Society on a noteworthy intangible asset finance matter.*

But the evolution of robust capital markets to utilise intangibles has been slow. Deals are few and far between. Each transaction seems to be unique. While not quite a case of re- inventing the wheel, there appears to be no standard template for quickly processing these transactions.

An opportunity in disguise

With recent problems in the subprime mortgage market and asset-backed securities, development of an intangible-backed capital market is threatening to come to a halt. At a panel at the recent securitisation conference in Las Vegas, some spoke of how they expect transactions in these "exotic" asset classes to continue. But it is clear that continued investor wariness will be the hallmark of the securitisation market.

The current market trouble may present an opportunity for intangibles. Intangible asset-backed securitisation may provide a successful counterpoint to the complex and overly risky offerings that have plagued the markets. As some have noted, the complexity of past deals has not been in the structure of the deal – they have been relatively straightforward compared to other types of offerings. Instead, the complexity is in the nature of the assets themselves.

Intangibles are different from physical and financial assets. Intangible assets include a wide range of categories. The most recognisable is intellectual property, such as patents, trademarks, designs, licenses, copyrights, film rights, mastheads and trade secrets. But contractual rights are also included, such as business agreements, licences and franchise rights, quotas and resource allocations (eg, airport landing rights and water rights), and employment contracts. Beyond contractual or IP-protected rights are in-process R&D, information systems and databases, documented administrative structures and processes, documented market and technical knowledge, intangibles embodied in capital equipment, internally generated software, and drawings. Then there is the tacit know-how and skills of the workforce (often referred to as human capital), organisational flexibility and other competencies (often referred to as organisation capital), and external relations such as reputation, customer loyalty, customer satisfaction, links with suppliers, commercial power, negotiating capacity with financial entities (often referred to as relationship capital).

How big is America's intangible economy?

The size of intangible assets in the US economy and company valuation is a hotly debated topic. Leonard Nakamura of the Federal Reserve Bank of Philadelphia estimates that America invests over US$1 trillion each year in the creation of intangible assets. These intangibles – ranging from research and development activities, through marketing and from patents, to reputation – fuel economic prosperity. Of that trillion dollar plus investment, over US$400 billion is in firm-specific human and structural resources.

The Organisation for Economic Co-operation and Development estimates that the United States invested 6.6 % of GDP in 2002 in "knowledge" – limited just to R&D, higher education (public and private) and software.

Some have argued that a large portion of companies' stock market value is intangible. Keith Cardoza, Justin Basara, Liddy Cooper and Rick Conroy at OceanTomo estimated that for the S&P 500, book value is less than 35% of market capitalisation, and that the total value of intangibles is 79.7 % of market capitalisation (15.5 % captured within book value and 62.2 % not reported on the books). Juerge Daum, a well-known consultant and expert in intangibles, found that in 1999 intangible assets accounted for an estimated 84% of the asset composition of market value of the S&P 500, a 121% increase in less than 20 years.

Others point to that fact that national statistics show overall market capitalisation to be generally below market value of corporations' tangible assets (mainly real estate).

Another estimate, by the analysis firm Brand Finance, places the total value of intangibles in the US in 2005 at 71% or US$9.2 trillion. In a paper for USA For Innovation, Robert Shapiro and Kevin Hassett estimated the value of US intellectual capital at more than US$5 trillion, based on imputation from current stock market values. On brand value alone, the estimate is large. The total brand valuation of just the 52 US companies listed in Business Week's top 100 brands is almost US$722 billion.

Yet those investments and the wealth they create are largely hidden. They do not show up on corporate balance sheets or in economic statistics. Of the US$9.2 trillion of intangible assets estimated by Brand Finance, only a small portion are disclosed intangible assets; the vast majority (over 55% of total enterprise value) is in "undisclosed value"; ie, not in companies' financial reports. The author of this paper has calculated that the value of uncaptured intangibles in our trade statistics is estimated to be US$640 billion to US$785 billion.

In a path-breaking set of papers, Carol Corrado, then at the Federal Reserve in Washington DC, Charles Hulten, of the University of Maryland and Daniel Sichel from the Federal Reserve, undertook a comprehensive assessment of the size of intangibles in the US economy. They estimate that as much as US$800 billion in annual investments is still excluded from our national economic statistics. As a result, the size of US business capital stock is off by US$3 trillion of intangibles.

Capital market problems

Not all types of intangibles are candidates for utilisation in the capital markets. In order to be used as collateral for a loan or as part of an asset-backed securitisation they must have certain characteristics. Chief among these are separability and transferability. Both are needed so that ownership of the asset can be moved from one party to another: a key feature for using the asset as collateral. Some forms of intangible assets are difficult to break into discrete, separable entities.

Those that can be formalised, such as patents and copyrights, can generally be separated and transferred. But often these assets are bundled with tacit know-how and other associated intangibles. In licensing

agreements, a side agreement on the transfer of know-how is sometimes needed. Management and servicing agreements are important parts of securitisation of brands and trademarks.

Issues of duration must also be addressed. Patents, copyrights and trademarks all have different lengths of intellectual property protection. The value of the asset obviously changes dramatically after the expiration of that protection. The underlying value of those intangible assets is also subject to rapid market changes, as technology develops and consumer tastes shift. Thus the investor has to confront the question as to whether the value of the asset will outlive the duration of the financial commitment.

Valuation and risk analysis are other important concerns. Operational risk, market risk and event risk must all be taken into account. For some intangibles, this analysis can be daunting. Take for example, the risk associated with a brand. Operational and market risk can be analysed but event risk, such as a devastating product failure resulting in the loss of brand reputation, may be unknowable.

Given the thinness of existing markets for intangible assets, valuation issues loom large. Rather than being priced on market data, valuation methods must rely on imputation and historical costs. Context and the associated bundle of concomitant intangibles are important in arriving at a valuation. Because an asset such as a patent may be used in different ways – for example, as a core technology in a key product, as a non-core defensive position or as a source of licensing revenue – the valuation may differ by use.

Creating a market

A major step forward in utilisation of intangible assets in the financial system will be the development of primary markets in the actual intangible assets themselves. A functioning asset market is needed for both liquidity and valuation purposes. Not only are the securitisation instruments potentially illiquid, the underlying asset itself may be difficult to sell. Creation of live IP auctions (such as those organised by OceanTomo) and internet-based website markets will strengthen the liquidity of these assets, thereby easing some of the uncertainty and market risk. Creation of more market pricing information will also better inform the valuation process. With the current thin market, the valuation process must rely on only costs and income (royalty) information. Having more actual market transaction prices will create a more robust valuation process.

Ultimately, the challenges facing monetisation of intangible assets boil down to complexities of the deals and high transaction costs. In the end, costs to companies using intangibles assets to raise capital may simply not be worth the effort, especially when compared with traditional alternatives. A standardised market and deal structure to reduce transaction costs and simplify the contract is needed.

The policy role

To realise the promise of intangibles, industry standards and government regulation need to be developed to promote acceptance, use and dissemination of intangible assets in the market. Ranging from securities and banking regulations to perfection and bankruptcy law to accounting standards, changes are needed (see box on page XXXX).

SEC and FASB reporting requirements need to be modified to account for intangibles better than they do currently. As a first step, FASB and the International Accounting Standards Board (IASB) should reinstate their research project on expanded disclosure guidelines for intangibles. There is no reason to continue to treat internally-generated intangibles differently to the exact same type of intangible purchased from outside. The SEC should create a safe harbour in financial statements for corporate reporting of intangible assets.

Valuation methodologies need to be examined, especially in light of the implementation of new fair-value accounting standards. Recently, the SEC sent guidance letters to 30 company CFOs regarding the use of these new standards and, in a rare move, then posted a sample letter on the agency's web site. The key requirement of this guidance involves an explicit discussion of the methodology used to price assets as part of the MD&A section of the company's financial report. While this was aimed at financial instruments, this way of handling valuation concerns could just as easily be applied to intangible-backed lending and securitisation (and all other exotic asset classes). To follow up, the SEC and FASB should convene a joint task force on valuation to review the experiences of companies in complying with the new SEC guidance – and to see what lessons might be learned for standardisation of a valuation methodology.

The US Capitol
It is time for US policy makers to come to grips with the intangible economy

Other financial regulations need to be examined, including treatment of intangibles in Sarbanes-Oxley. Sarbanes-Oxley tightened up the requirements that companies disclose all information deemed to be material to the company's financial situation. Some companies have begun to audit and disclose information on intangibles under this requirement. But the practice is not yet widespread. A clear set of guidelines from the SEC and Congress as to the need to disclose key information on intangibles is needed.

Banking and lending policies and regulations need to be examined. For example, the Basel II Capital Accords – a subject of great concern currently – should also be examined for their impact on intangible assets. It is unclear whether intangibles can be included as a recognised form of collateral, even if they are producing a steady revenue stream. The federal government should also review its business loan programmes, especially in the small business arena, to ensure that intangible assets can be used as collateral.

There also need to be ways to ensure that intangible-backed assets are properly included in ongoing efforts at market reform, such as the President's Working Group on Financial Markets.

Other simple changes are needed, such as creating a system for tracking legal claims on an asset, known as perfection. Right now, there is no national system of knowing who has a financial claim on a patent, for example. State-level systems for perfection of security interests may work for tangible assets, where the relevant geographical location is easily determined. For an intangible, that location may be difficult to determine. The US Patent and Trademark Office is already undertaking a pilot programme. As soon as the pilot system is publicly available, it should be quickly evaluated with an eye towards rapidly expanding it into a national central registry, along the lines of the legislative models already proposed.

The issue of patent reform must be confronted. Whether you support or oppose certain provisions in the Patent Reform Act, everyone should agree that investors need to know that they are investing in valid patents, not the IP equivalent of Florida swampland. In that regard, the role of patent litigation and patent liability insurance should be examined. A workable insurance system, covering both the cost of bringing litigation

Possible policy-related actions

To help in the development of a market for intangibles, there are a number of things that the US government, policy makers and regulators can do.

Identification and disclosure

- Reinstate the joint FASB and IASB research project on expanded disclosure guidelines for intangibles.
- Review and revise SEC definitions of asset-backed securities to include intangible asset classes.
- Clearly designate non-financial measures for evaluating intangibles in the MD&A portion of financial statements.
- Create a safe harbour in financial statements for corporate reporting of intangible assets.
- Modify Sarbanes–Oxley so that there is a clear directive for assessments of material intangible assets.
- Utilise the stock exchanges (and the proposed Intellectual Property Exchange in Chicago) as initial testing grounds for increased intangible disclosure by requiring listed members to make additional disclosures that capture intangible metrics.
- Create an intangibles reporting and valuation guideline association/group, similar to the International Private Equity and Venture Capital Valuation Group and the Enhanced Business Reporting Consortium.

Valuation standards

- Convene a special FASB/SEC task force on valuation.
- Support and encourage increased research on valuation standards.
- Work with the International Standards Organisation's efforts to set brand and patent valuation standards to ensure that relevant expertise and stakeholders are engaged.

Regularising the market

- Explore the creation of an Intangibles Mortgage Corporation (Ida Mae) to regularise the intangibles-backed securities market, either as a limited government-sponsored enterprise (GSE) or as an independent organisation.
- Review all security regulations to determine their applicability to intangibles.
- Review federal and state insurance laws, and regulations to promote the development of financially sound insurance coverage of intangibles.

Market oversight

- Work with credit rating agencies and monoline insurers to provide a transparent process for rating intangible asset values.
- Coordinate with ongoing efforts at market reform, such as the President's Working Group on Financial Markets, to ensure that intangible-backed assets are properly included.

Perfection

- Create a national central registry of intellectual property security interests.

Tax incentives

- Create a permanent knowledge tax credit that would increase investments in intangibles.
- Explore lowering the tax rate on intangible asset royalties, in conjunction with stricter regulations on international transfer pricing mechanisms and cost-sharing arrangements, and on passive investment companies.
- Review the impact that expensing versus depreciation has on investment in intangibles, including a review of the impact of the 2002 IRS regulations, *Capitalizing Intangible Assets*.
- Undertake a comprehensive review of the tax code as it relates to intangibles.

Patent reform

- Create a pre-review pilot programme at the US Patent and Trademark Office (USPTO).
- Continue other efforts at the USPTO to increase patent quality in consensus with relevant stakeholders.
- Enact patent reform legislation.
- Undertake a review of patent litigation and patent liability insurance.
- Review federal and state technology policies to encourage promotion of patent pools.

Spurring licensing

- Undertake a review of how the federal technology transfer system, including Bayh–Dole, does or does not facilitate creation of intangible assets.

Facilitating lending

- Undertake a review of the Basel II Capital Accords to understand better their implications for intangible-backed lending.
- Review Small Business Administration (SBA) laws and regulations to ensure that SBA loans can be used for the acquisition of intangible assets, and that intangible assets can be used as collateral for such loans.
- Require the SBA to work with its commercial lenders to develop standards for use of intangible assets as collateral, similar to existing SBA underwriting standards.
- Undertake a review of all other federal government business loan programmes to ensure that intangible assets are properly treated.

Taken from Jarboe and Furrow, Intangible Asset Monetization: The Promise and the Reality, Athena Alliance, April 2008, www.athenaalliance.org

and the cost of potential liability, might be able to serve as a replacement for the defensive patent syndrome.

Even the tax code comes into play. Thought needs to be given to creating a permanent knowledge tax credit that would increase investments in intangibles and to the capitalisation of intangibles. Such a tax credit would expand the current research and experimentation tax credit to include investments in worker training and skill development.

The issue of transfer of intangible assets to offshore entities for tax purposes is becoming a major concern among tax agencies and policymakers. Government officials are concerned that these transfers are taking place at less than market value and being done solely to escape taxation. Companies argue that they are legitimate aspects of the globalisation of knowledge. As an incentive to get such intangibles in the US, we might want to think about exploring a lowering of the tax rate on intangible asset

royalties, in conjunction with stricter regulations on international transfer pricing mechanisms and cost-sharing arrangements and on passive investment companies.

Efforts to create standardised products should be encouraged. Here the government may have a lesser role. But creation of the intangible asset equivalent of the conforming loan mortgage would go a long way to regularising the market. In the mortgage market, standardisation was brought about by the creation of government-sponsored enterprises (GSE), most notably Fannie Mae and Freddie Mac. The secondary market in student loans was jump-started by another GSA, Sallie Mae, which later converted to a private company. Thus, we should explore creation of an Intangibles Mortgage Corporation (Ida Mae) to regularise the intangibles-backed securities market, either as a limited GSE or as an independent organisation. While the current role and need for Fannie Mae and Freddie Mac, in particular, is controversial, there is little argument about the importance they played in creating the mortgage market. Any intangible asset version of a GSE should be undertaken with care. But the idea should not be dismissed out of hand.

Finally, we need to increase the supply of intangibles coming to the market. As mentioned earlier, companies do not track their own intangibles. They do not know the extent of that hidden wealth. Government actions to increase the reporting of intangibles will not only help outside investors determine the true value of the company, it will help executives better manage those assets. The federal government might also want to look at the efficacy of its own technology transfer efforts to get government-created intangibles out to the marketplace.

Seizing the opportunity

In this time of credit market turmoil, there are both challenges and opportunities for intangible assets. By supporting efforts to improve transparency, strengthen credit standards and simplify transactions, both government and private-sector actors can unlock a vault of useful financial instruments. Monetisation of intangible assets can open up a new avenue for financing innovation and business expansion.

Events of the past year have highlighted problems in the capital markets. Attention is now being directed at fixing those problems. As we move forward with the remedies, it is important that we look to the future as well as the past. Monetisation of intangible assets will require newly relevant policies and structures that unleash the economy from the strictures of the past.

Perhaps the single most important step is the recognition that intangible assets are not covered in existing financial structures. There clearly is something novel about the new economy. Intangible assets – knowledge, ideas, skills, relationships and organisation – have taken on greater worth. Monetisation of those intangible assets is one step in the process of value creation. As the economy continues to evolve, our policies and structures for monetisation need to adapt as well. Creating a market and a regulatory system that embraces intangible assets will set the stage for future economic growth. ■

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