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KEY CONSIDERATIONS FOR SECURITIZATION OF INTANGIBLE ASSETS IN LENDING TRANSACTIONS

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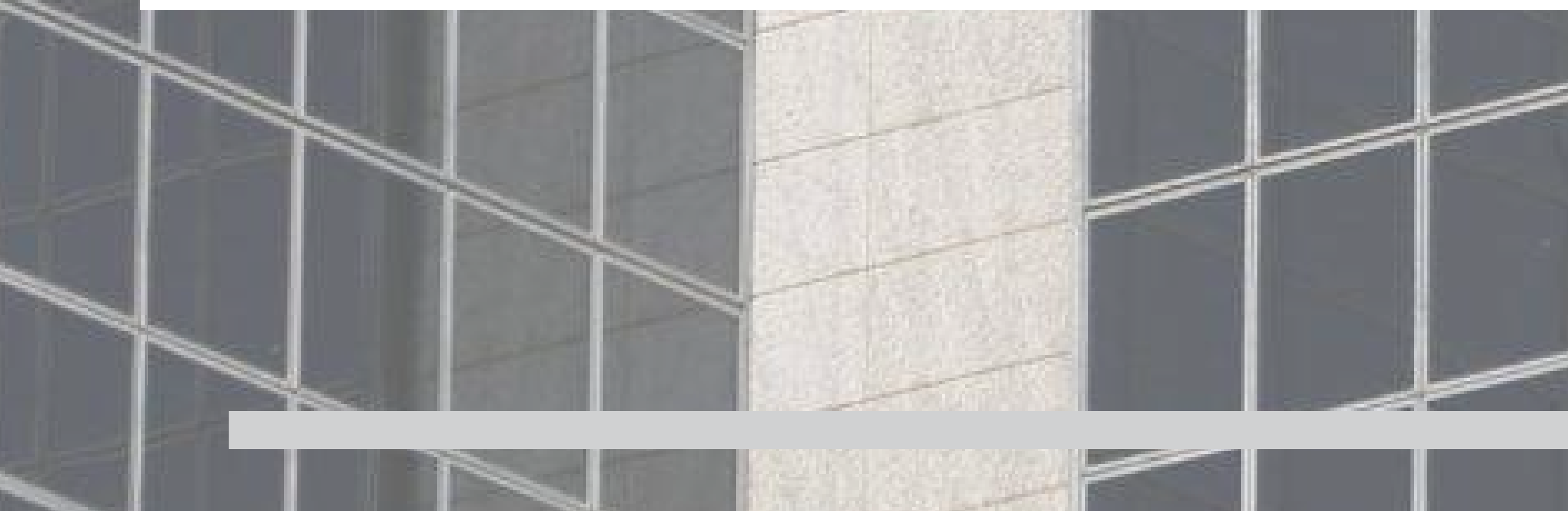
INTRODUCTION

Historically, tangible assets (such as real estate, equipment and vehicles) have been the primary input into economic value creation, while intangible assets are not considered viable security by lenders and are generally rejected as the principal collateral in lending transactions. Over time, however, intangible assets such as intellectual property, know-how, brand and creative output have become increasingly important as they allow other forms of value to be generated. There has been a growing acknowledgement over the last few years among lenders and investment bankers that the intangible assets of a company, particularly its intellectual property (**"IP"**), are of significant value.

What is securitization of Intangible Assets?

Securitization is a financial model wherein the future cash flow obtained from an asset is used as a guarantee for repayment of debts. According to Clause (A) (xvii) of the Rules of Securitization (the **"ROS 2015"**) issued by the Securities and Exchange Commission (the **"SEC"**) in 2015, securitization means "the issuance of securities backed by a pool of assets". Clause G of the ROS 2015 allows for securitization of all standard assets on a balance sheet of a business, save for revolving credit facilities, encumbered assets, securitization exposures and loans with bullet repayment of both principal and interest. This means that intangible assets can be securitized.

Securitization of assets backed by future income streams continues to experience significant growth as a leading source of financing and as a replacement for traditional financing methods such as obtaining bank credit or issuing corporate bonds. This indicates that intangible assets are now being readily accepted as business assets. Post-COVID, there appears to be an increased recourse by major corporate borrowers to securitization of intangible assets as a viable financing alternative. Sometime in June last year, United Airlines Holdings, Inc., a publicly traded airline holding company in the United States (the **"U.S."**), announced its plan to mortgage its frequent-flyer program to secure a US$5 billion loan under a deal structured by three U.S. banks viz., Goldman Sachs, Barclays Bank and Morgan Stanley.



According to the International Financial Reporting Standards (the **"IFRS"**), intangible assets are identifiable, non-monetary assets without physical substance. Paragraph 9 of the International Accounting Standards (the **"IAS"**) 38, provides a definition of intangible assets as "**intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licenses, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licenses, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights"**. Same as all assets, intangible assets have important long-term value for the functioning of a business, therefore it is expected that such assets will generate economic returns in the future for the business.

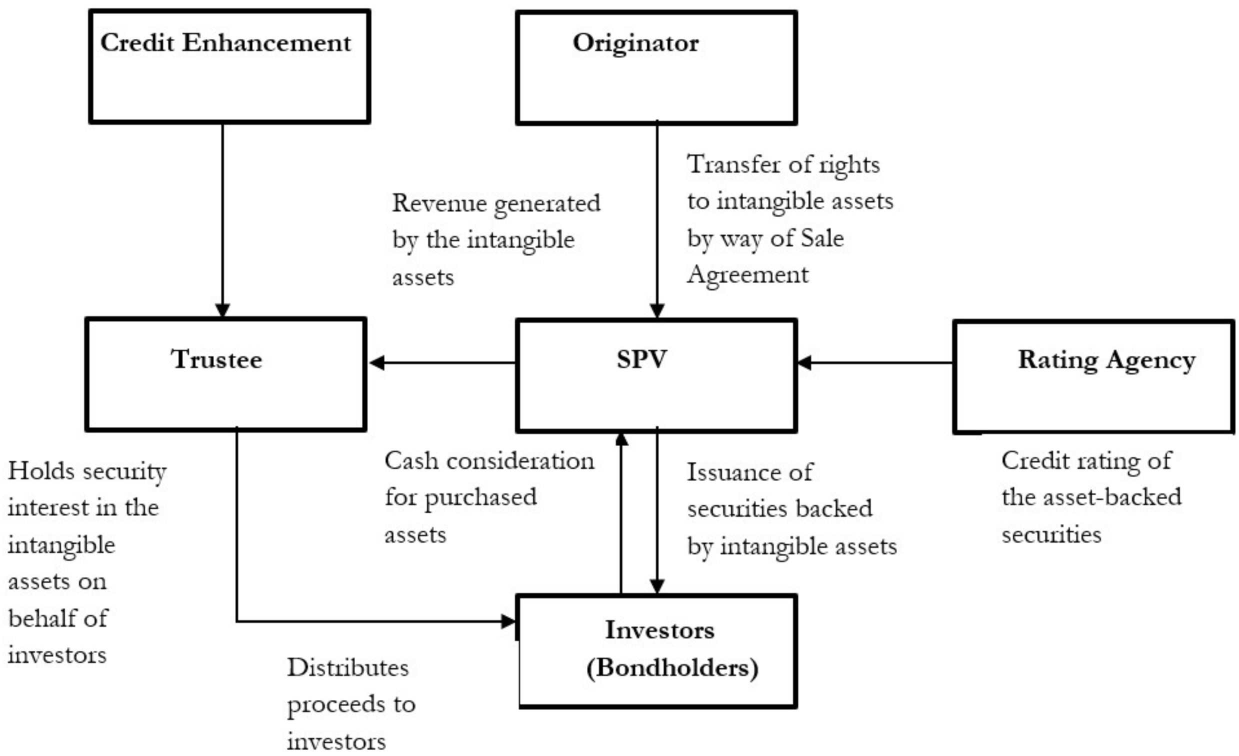
According to the Financial Accounting Standards Board, intangible assets are classified as follows:

Market-related intangible assets	Customer-related intangible assets	Artistic-related intangible assets	Contract-based intangible assets	Technology-based intangible assets
Trademarks, tradenames, collective marks and certification marks; trade dress; newspaper mastheads and internet domain names.	Customer lists; customer contracts and order or production backing.	Plays, operas and ballets; books, magazines and newspapers; other literary works Musical works; compositions; song lyrics and jingles Pictures; photographs, video and audio-visual material.	Licensing agreements, royalties, standstill agreements; construction service contracts; lease agreements; franchise agreements; operating and broadcast rights and non-compete clauses in employment contracts.	Patented technology; computer software; databases and trade secrets.

HOW DOES SECURITIZATION OF INTANGIBLE ASSETS WORK?

In a basic transaction structure involving securitization of intangible assets, the holder of the intangible assets creates a special purpose vehicle (the **"SPV"**), which in accordance with Clause C (1) of the ROS 2015 shall be incorporated as a public limited liability company, a trust or any legal entity permitted by the SEC for a securitization transaction, to hold the title to the intangible assets underlying the securities and transfers the title to the SPV by way of a Sale Agreement. The SPV finances the procurement of the securitized assets by issuing securities that are backed by the intangible assets (referred to as **"asset-backed securities"**). The intangible assets and the proceeds from the intangible assets, are used as security to secure the SPV's obligations to pay the principal, interest and any amounts due to the investors. The cash flow generated by the underlying intangible assets funds the payments to investors.

Basic Structure: Securitization of Intangible Assets



While we briefly consider variations of securitization structures involving intangible assets below, particular reference would be made to IP; reason being that IP is easier to quantify than other intangible assets.

Royalty Interest Securitization

In this variation, the deal is backed by an existing royalty stream emanating from an IP. The IP is sold by way of a true sale to an SPV that procures it via the issuance of bonds backed by the IP's revenues and the owner of the IP obtains cash from the investors upfront, while payment of the principal and interest is made to the bondholders (investors) with the royalties proceeding from the IP.

Revenue Interest Securitization

In this variation, no cash flow has been derived yet from the existing license or royalty agreement in respect of an IP or other intangible asset. The investor is inclined to the provide early funding for the commercialization of the IP, with the expectation that future licensing and product sales will generate revenue. Under such circumstances, the investor may require an equity position in the SPV.

Loans Collateralized by Title to Intellectual Property

In this variation, a company holding a number of patents in its portfolio can borrow a percentage of the value of the portfolio from a lender by deploying the patent portfolio as collateral. This method of financing is beneficial for a small inventor with valuable patents, but unable to procure financing for products and markets based on such patents. Such loans allow the inventor to generate cash without giving equity. An example of such a patent backed loan transaction is a US$17 million financing raised by GIK Worldwide, a small-scale technology company with valuable patents in technology for delivering high-speed broadcast quality video conferencing. As an alternative to accessing the venture capital market, GIK procured a loan from Pitney Bowes Capital and collateralized the debt by deploying its patents, which were valued at US$57 million.

KEY CONSIDERATIONS REGARDING SECURITIZATION OF INTANGIBLE ASSETS

There are certain vital issues that should be taken into consideration before a lender proceeds to accept intangible assets from a borrower as security enhancement in a lending transaction, as delineated below:

Due Diligence

As a preliminary point, it is imperative that a proper due diligence ("**DD"**) is conducted; a prospective lender needs to conduct a DD exercise before intangible assets are accepted as security. The DD should address some key questions, such as:

Is legal ownership of the IP right actually vested in the borrower? Has registration been procured, where applicable? Has the relevant licensing, franchising or sale and purchase agreement been duly examined?
What is the status of the IP? Does the validity still subsist? Have all maintenance or renewal fees been duly paid up to date?
Is the IP free and clear of all encumbrances? Are the pertinent IP rights subject to any pre-existing mortgage, lien, charge or claim of any kind?

Where legal enforceability has not been determined and a lender is unable to take possession of the IP in the event of a default, the lender would be unable to dispose of the IP assets and recover any loss suffered. Therefore, lenders and investors would need to be satisfied that the borrower has taken all necessary steps to identify, protect and manage its IP and other intangible assets.

It is important to note that IP rights do not exist in perpetuity; grant of patents subsist for twenty (20) years while trademarks require renewals after a period of seven (7) years. Therefore, the parties to a securitization transaction involving IP-backed securities should be aware that the tenor of the transaction cannot exceed the life of the IP assets.

VALUATION

What is the value of the intangible asset? Determining the scope and value of a company's intangible assets is one of the threshold issues for lenders in deciding whether and how much to loan a borrower pledging its intangible assets as collateral. Unlike tangible assets such as inventory and equipment whose value can be determined by established methodologies, the mode of determining the value of a company's intangible assets is largely based on speculation.

The absence of a consensus approach and the lack of transaction data makes it difficult to independently verify the value attributed to an intangible. The complexity of valuation in respect of intangible assets therefore requires the expertise of an independent specialist. The uncertainty that this presents makes it difficult for a lender to know how much it could possibly recover in the event of default. Consequently, if a company defaults because it is unable to commercialize its intangible assets, there is a likelihood that such assets may lack commercial value elsewhere.

In view of the foregoing, it is important for businesses to recognize the importance of valuing their intangible assets, particularly when they may have significant value, in order to provide reassurance to lenders. While it can be difficult to ascertain the economic value of an intangible asset, there are some steps that can be employed in determining the approximate value, as delineated below:

Determine the market value of the business by ascertaining the price a purchaser would be willing to pay for its acquisition;
Calculate the total value of the tangible assets; and
Deduct the net tangible assets from the market value and the result would be an estimated value of the intangible assets.

The value of intangible assets can also be calculated by using the following methods:

1. Cost Method

This method is applied by extrapolating or ascertaining the cost expended by another company in the creation of a specific intangible asset.

2. Market Method

This method is applied by finding out what the market value of an intangible asset is and how much other businesses are willing to pay for a similar asset.

3. Income Method

This method is applied by using cash flow projections to calculate how much profit an intangible asset would bring to a business.

LIQUIDITY

The absence of established liquid secondary markets for intangible assets presents a challenge for price discovery and asset disposal. There is no assurance of immediate liquid cash value and thus, a lender that accepts an intangible asset as collateral risks being saddled with an asset that it is unable to dispose. Lenders and investors want some level of assurance that they will reclaim some of their money, in the event of default. In order to realize this, lenders will require access to a robust market for the collateral where the intangible assets can be liquidated. Any asset with a low recapture rate, such as 10 to 40%, is most likely going to attract only the most risk-tolerant investors.

CONCLUSION AND RECOMMENDATIONS

Despite the apparently preponderant detractions, securitization of intangible assets is a valuable tool for achieving significant business growth. The practice requires a conducive environment to thrive and here are some recommendations that could facilitate this:

POLICY INTERVENTION

In order to effectively deploy intangible assets in the financial system, quantifiable metrics of their characteristics must be made available so that financial markets can calculate those assets' behavior over time. Policymakers need to assist in making financial statements more transparent. Workable financial markets require consistent, accurate, and useable information on prices and values. It is the responsibility of regulators in the financial space such as the Central Bank to ascertain whether and to what extent lending institutions are using intangible assets as loan collateral by collecting data. Concerted efforts should be made by pertinent regulators to discover how intangible assets are valued by lending institutions for the purpose of assessing collateral and thereby determining appropriate policies that take cognizance of the peculiarities associated with intangible assets.

Improved accounting/reporting standards

Since a major drawback for intangible assets is the reliability of the information available, a lender would need to be satisfied with the reliability of the appraisal or assessment of an intangible asset before such assets is accepted as collateral. Therefore, in order to achieve the required transparency, accounting and reporting standards must be modified to facilitate an improved accounting for intangible assets. Once the practice of keeping accurate records of intangible assets is maintained by businesses, it would prove useful not only in fostering the increased use of financing backed by intangible assets, but in promoting the safety and soundness of the financial sector.

Insurance

The presence of insurance for intangible assets also offers objective external evidence of their value. Where a business decides to insure its intangible assets, disclosure of the practice and the insured values could provide useful information to lenders and investors. The value they are willing to insure could be used for purposes of lending, borrowing, or financial reporting. Such a disclosure could help bridge the gap between reported values and market values. Insurance can be instrumental in driving additional commercial benefits that could offset some of the costs of traditional risk management. Whilst a range of insurance products already exist that can help businesses manage risks pertinent to intangible assets such as reputation, human capital, and IP litigation, it is imperative that insurers, risk owners, and risk managers work conjointly to further develop these products.

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RIVER JAMEISON SPV LIMITED –

Tokunbo Orimobi LP is pleased to officially announce the closing of the N24.5bn series 1 tranche A Bond Issuance Exercise under the N25bn Bond Issuance Programme by River Jamieson SPV Limited, sponsored by the Edo State Government.

Tokunbo Orimobi LP acted as Lead Solicitors to the Issuer on this deal and we are proud to be one of the few Law Firms in Nigeria to have advised on deals of this nature in 2020.

We congratulate our Securities, Mergers & Acquisitions Team for a job well done.

RAEDIAL FARMS LIMITED -

Tokunbo Orimobi LP is pleased to officially announce the closing of the N2bn Bond Issuance Exercise under the N5bn Bond Issuance Programme by Raedial Farms Limited.

Tokunbo Orimobi LP acted as Solicitors to the Trustees on this deal and we are proud to be one of the few Law Firms in Nigeria to have advised on deals of this nature in 2021.

We congratulate our Finance, Corporate and Commercial Team for a job well done.

CAPITAL EXPRESS GLOBAL ASSET MANAGEMENT LIMITED -

Tokunbo Orimobi LP is pleased to officially announce the closing of the 12% Fixed Rate Notes Issuance Programme by Capital Express Global Asset Management Limited.

Tokunbo Orimobi LP acted as Transaction Counsel on this deal and we are proud to be one of the few Law Firms in Nigeria to have advised on deals of this nature in 2021.

We congratulate our Finance, Corporate and Commercial Team for a job well done.