

Recent Securitizations Of Licensing Revenues

BY HENRY BECK*



The recent difficulties in raising funds in the capital markets and via the venture capital route have renewed interest in securitizing cash flows from intellectual property assets, perhaps thereby presaging a revival of this form of financing for companies possessing the appropriate intellectual property assets and seeking a lower cost of capital.

One recent deal closed on April 23, 2003, when Guess?, Inc.—a Los Angeles-based company that designs and markets apparel, accessories and consumer products—raised \$75 million in a trademark securitization. Other recent reported IP securitizations have included Yale University's \$100 million securitization of its royalty interest in an AIDS drug, and DreamWorks' much larger film securitization, which raised \$1 billion dollars on the basis of the rights in DreamWorks' existing film library and rights in films yet to be made by the studio. Several other transactions have taken place in the past few years, including the securitization of Bill Blass' trademark portfolio, the proceeds of which were used in a leveraged buyout. Since nearly all of these financings have been non-public transactions, little additional information is available about them, but an examination of the costs and benefits of such financing may enable candidate companies to determine whether securitizing their licensing revenues is something they should examine.

How IP Securitization Works

In a typical IP rights securitization, a company (usually referred to as the "originator") sells rights in a stream of royalties or license fees to a special purpose, bankruptcy-remote vehicle (SPV). The transaction is tailored to

be a "true sale," rather than a form of lending secured by the transferred assets. The SPV, in turn, issues securities (generally debt securities) to capital market investors.

The SPV uses the proceeds of the issuance to pay for the rights transferred to it. Investors, who are repaid as the royalties or license fees are collected, buy the securities based on assessments of the value of the cash flows, rather than the balance sheet of the originator, such assessments generally being based on the ratings assigned to the securities by one or more rating agencies, such as Standard & Poor's or Moody's.

Because the SPV (not the originator) now owns the assets, the investors' decision to purchase can be made without concern for the originator's financial condition. Thus, viable companies with problematic balance sheets that otherwise cannot get lower-cost financing can now do so. Even companies that can otherwise obtain financing should be able to obtain significantly lower-cost funds. These funds, in turn, can be used to meet capital funding needs, finance research and development, and help pay for a commercial product launch or for other corporate purposes.

The losers? The originator's unsecured creditors, for whom the assets transferred to the SPV may now be out of reach.

Music Royalty Securitizations

The first reported IP-backed securities were issued in 1997 by the rock and roll artist David Bowie. These "Bowie Bonds," based on the singer's music rights, enabled him to raise \$55 million, which he reportedly used to settle a dispute with the United Kingdom's tax authorities. That securitization was fol-

lowed by a flurry of others involving such well-known artists as Ashford & Simpson, James Brown, and the Motown songwriting team of Holland, Dozier and Holland.

However, by the end of 2000, it had become apparent that using music royalties (rather than patents, trademarks or other types of copyrights) as a basis for securitization might not be optimal. Among the concerns were that:

- well-compensated entertainers might have less need for cash than capital-hungry companies;
- income streams generated by music royalties were not as predictable as other forms of licensing revenues; and
- intellectual property chain-of-title issues were especially difficult in the music industry.

More recent IP securitizations, based on other types of IP rights, avoid these problems. In the Guess? deal, for instance, the company securitized the future cash flows from a pool of twelve of its domestic and two of its international trademark license agreements. The licenses grant their respective licensees exclusive, non-transferable rights to use certain of the Guess? trademarks on specific apparel and apparel-accessory products, like watches, eyewear and handbags. Each agreement requires the payment of the higher of a minimum payment or a percentage of sales. On the basis of royalties which were projected to remain between \$23 million and \$22 million a year

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for the first few years of the issue, before declining sharply thereafter as the licenses expired, Guess? was able to raise \$75 million on very favorable terms, which it then used to retire much more expensive debt.

The terms on which other companies will be able to use this financing method will depend on the types of standard credit analyses carried out by bankers and credit rating agencies and the degree to which the securities issued are supported by over-collateralization (borrowing an amount equal to only a percentage of the expected royalties) and credit enhancement (such as a third party guarantee, which increases the attractiveness, and hence lowers the interest cost for such issues).

Companies which are good candidates for such transactions include those with stable royalty flows from creditworthy licensees going out for between five and ten years, and whose balance sheets may not support borrowing at interest rates comparable to those which may be available in a securitization. Pharmaceutical and medical device, and telecom-IT patent royalties, well-known consumer product trademarks, and similar IP rights may make for the best securitizations.

The key is cash flow. The larger and more diversified the portfolio of licensees and the royalties to which the originator of the securitization is entitled—and hence the stability and predictability of expected cash flows—the more attractive such transactions are to investors. While the larger and more noteworthy transactions such as the Guess? and Yale-Zerit offerings have involved annual royalty streams greater than \$20 million—and large underwriters are particularly interested in such larger transactions—smaller deals have also been done.

In this regard, there is considerable interest in pooling the royalty rights of a number of licensors to achieve critical mass, in much the same way as other sorts of debt are pooled, in order to expand the number of licensors who will be able to take advantage of this often favorable financing vehicle.