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Financing Intangible Assets And The Digital Economy

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FINANCING INTANGIBLE ASSETS AND THE DIGITAL ECONOMY

I. Intangible Assets and the Digital Economy

With the advancement of technology in the digital economy, one primary development is the rise of Intangible Assets (**IA**), namely assets that are non-physical and non-monetary in nature.

IA have progressively formed the bulk of the assets of companies and accounts as the main driver of performance beyond tangible assets, such as machinery, equipment and buildings. This trend will continue with more companies pivoting towards the digital economy.

Given the increasing significance of IA in the digital age, there will correspondingly be opportunities and risks in the financing of IA. Lenders have to understand (a) the IA strategy of companies and (b) the financing considerations relating to IA such as financing structures, credit analysis, due diligence, maintenance, security and enforcement.

II. IA Strategy

A lender must first understand the IA strategy of companies and how IA contribute to and support their business and growth. The strategy will usually include the identification, management and protection, insurance, valuation, leverage and use of the IA.

(1) Identification

The first step is for companies to identify and categorise their IA. It should also accurately describe the nature and characteristics of the IA within the context of their business.

There are many ways for companies to categorise IA. Broadly, it can be related to (a) technology, (b) intellectual property and (c) business and operation. There is no fixed definition or grouping of assets within each category and would probably include the following assets:

a. Technology related – computer program, software code, written process, technology, algorithm, website and domain name, smart contract and data portal;
b. Intellectual property related – copyright, trademark, patent, invention, design, confidential information and research and development; and
c. Business and operation related – brand equity, reputation and goodwill, business methodology and strategy, know-how and business processes, market intelligence and experience, advertising and marketing, relationships, networks and supply chains, regulatory and financial barriers and human capital.

With the increasing focus on environmental, social and governance (ESG) factors, a company's positive ESG attributes will also form part of its IA.

(2) Management and Protection

It is crucial to properly manage and protect IA to preserve and maximise their value and minimise the risks posed to and from IA. This will largely depend on the nature and location of the IA as well as the applicable legislations.

Internal safeguards include policies and processes against unauthorised access and use, mismanagement, neglect, abuse and abandonment of IA. Access to valuable confidential IA should only be on a "need-to-know" basis. There should be regular training on IA management and protection and systematic IA audits to optimise a company's IA portfolio, thereby improving the overall quality of the IA and eliminating wasteful assets and processes.

External safeguards include utilising public registration mechanisms, constant monitoring and legal actions against the abuse and infringement of IA by third parties.

(3) Insurance

The insurance for IA differs from tangible assets due to the nature of IA. It is usually more specialised and bespoke. Examples of insurances for IA include:

a. Technology related – cyber insurance, custody insurance and errors and omissions insurance;
b. Intellectual property related – loss of the intellectual property rights and profits; and
c. Business and operation related – non-physical damage business interruption, supply chain disruption, loss of human capital, negative publicity and management liability.

Some of the challenges relating to insuring IA are the lack of knowledge of such insurance, uninsurable IA due to mismanagement, high premiums due to the nature of the IA and the difficulties in proving causation in the event of a claim.

(4) Valuation

Fair and proper valuation of IA is critical to ensure that their market values are accurately reflected in a company's balance sheet to fully maximise their value, as well as the leverage and use of the IA. Unlike tangible assets, it is relatively difficult to value IA due to their sui generis nature. Guidance on valuation can be taken from the International Valuation Standards Council, which aims to create an international valuation standard to ensure consistency and credibility in valuations and reporting related to IA.

(5) Leverage

Companies that properly identify, manage, protect, insure and value their IA can count on higher appraisals to attract capital from both the private and public markets. This is especially the case for companies that have IA as the bulk of their assets. In this regard, an established and credible disclosure framework on a company's IA will be useful and necessary for any successful capital fundraising exercise.

(6) Use

The strategic use of IA will enhance performance, productivity, growth, value creation and competitiveness.

There are several ways a company can put their IA to commercial use to generate value. Technology related IA will be very useful and critical in the digital economy. Intellectual property related IA will give a company exclusive rights over its creative assets and can be licensed for a fee. Business and operations related IA will give a company a competitive edge and opportunities especially in new markets. In general, IA can also strengthen the balance sheet and valuation of a company in the event of a sale, equity or debt raising.

III. Financing Considerations

There are broadly six key financing considerations in financing IA – (1) financing structure, (2) credit analysis, (3) due diligence, (4) maintenance, (5) taking security and (6) enforcement.

(1) Financing Structure

Companies in the digital age have evolved from traditional brick-and-mortar companies in terms of their asset composition and business models. They are increasingly asset-light with IA being their primary value source. They are also increasingly adopting the subscription model, especially in the technology, e-commerce and digital sectors.

The shift in the nature of corporate borrowers calls for a corresponding shift in financing structures. Traditionally, corporate borrowers are required to have a positive Earnings before Interest, Taxes, Depreciation and Amortisation (**EBITDA**) to obtain financing. However, companies in the digital economy usually have minimal or even negative EBITDA and initial low profitability, making them not “bankable” on traditional financing measures and models. However, they have potential for future growth and profitability. With IA driving a significant portion of company value, the finance sector needs to develop innovative financing products and structures to support the growth of such companies.

One example is the revenue-based finance model, where lenders provide financing based on annual recurring revenue instead of the traditional EBITDA model. This is suitable for a company which has initial low or negative EBITDA but reliable recurring revenue and future growth and profitability. Some of the key characteristics of an annual recurring revenue financing structure are:

a. Financing quantum – usually two to three times the annual recurring revenue with a flip back to an EBITDA model within two to three years.
b. Definition of annual recurring revenue and test period – depends on the deal in each case and is usually based on a rolling twelve months or shorter interval.
c. Financial covenants and restrictions – annual recurring revenue to debt and liquidity covenants.
d. Restrictions – more restrictive baskets (e.g. distributions, leverage, acquisitions) and easing upon a flip back to an EBITDA model.
e. Equity linked – lenders usually given equity upside via convertible loans, warrants or options.

On a related note, there will also be securitisation opportunities in relation to the recurring and reliable receivable. This will typically involve the sale of the receivable to a special purpose bankruptcy remote vehicle set up to issue bonds to purchase the receivable at an upfront discounted price.

(2) Credit Analysis

Valuation

The valuation of IA is integral in the credit evaluation of the borrower. There may not be a comprehensive and exhaustive intangible-specific valuation framework for most jurisdictions. There is also generally no active market or trading platform to reflect the value of most IA especially those that are unique. Hence, there is a need to develop accurate, reliable and accepted valuation methods specific to its context to quantify the value of the various forms of IA.

Loss of Value

Companies need to implement sufficient measures to guard against the devaluation of IA. There is a myriad of factors that may cause IA to lose their value. Internally, there may be mismanagement or negligence in dealing with the IA. Externally, there may be challenges and claims by third parties or fraud. The loss in value of IA may result in a direct loss in revenue, may take time to restore and in some cases, may be irreversible. Thus, it is important to ensure companies have robust internal and external policies to prevent the IA from losing their value.

Control of Secured IA

Lenders usually have control over secured tangible assets via legislations and other practical arrangements such as registration, custodian and escrow arrangements. It is harder to have control over secured IA due to the nature of IA which may also involve the use of new technologies that do not fall neatly into existing legal framework(s). While public registration of security over certain intellectual properties may be available in some jurisdictions, this may not be the case for other types of IA, where lenders must consider both contractual and practical safeguards to control secured IA against wrongful dealing and mismanagement.

Marketability

Marketability of IA refers to how easily the company’s IA can be sold to another party at a fair value. For example, a computer algorithm may be uniquely valuable to the company owning it, but it may be worthless to another company or industry. Hence, lenders should consider the marketability of the specific IA in the event they need to enforce the security taken over them.

Transferability

There are legislations and fairly established methods and processes to transfer tangible assets in most jurisdictions. However, the transferability of IA is more complex due to their evolving nature as an asset class and, in respect of certain types of IA, the relative lack of legislation and established transfer methods and processes. Due consideration must be given to the type of IA, contractual terms relating to the IA and the applicable laws and regulations. If possible, lenders should consider the various options such as self-help remedies, power of attorney, escrow and other custodian arrangements to facilitate transferability.

(3) Due Diligence

As part of the due diligence exercise, lenders should first identify the IA over which security is to be taken. Conducting due diligence checks on IA may be challenging if there is no public registry or established methods to conduct searches and due diligence on ownership rights, prior encumbrances and conditions to create security and transfer of the IA.

IA may also be subject to hidden risks that are difficult to identify, such as whether there are any infringements of the IA, any existing or pending litigation, challenges to the IA, prior encumbrances and problems identifying the holding structures and custodian arrangements. The party conducting the due diligence may also not have access to all the information necessary to make a thorough investigation of the IA, resulting in an incomplete or inaccurate assessment.

The risk of fraud related to IA is relatively higher than tangible assets due to the intangible nature of IA which makes it harder to monitor and protect against fraud. It is a relatively new and evolving asset class which may not be adequately covered by conventional fraud prevention and mitigation policies and processes. There is also less experience in dealing with such fraud. As such, lenders should do enhanced due diligence on the fraud prevention and mitigation policies and processes related to the IA.

One area of increasing importance is cybersecurity. This adversely and materially affects IA especially those related to technology, business and operations. Due diligence should be done on (a) the existing cybersecurity safeguards and policies (including recovery policies), (b) previous breaches and incidents, (c) previous recovery experience and success rate, (d) potential and future vulnerabilities and (e) cybersecurity insurance. There should also be representations and warranties from the company on the aforesaid.

(4) Maintenance

Another key financing consideration is the maintenance of IA. The maintenance of IA is imperative to preserve the value of the underlying asset over which lenders take security. Maintenance may involve compliance with legislative requirements, as well as registration and renewal regimes where applicable. The IA could be subject to possible validity challenges and infringements. Hence, lenders should consider the possible consequences of failing to defend against such challenges and infringements.

It is vital to formulate, implement and review internal policies, strategies and safeguards to maintain these IA. Such policies should be updated and audited regularly considering the evolving nature of certain IA as well as the changing nature of a company’s business strategy, which may render the relevance of some of its existing IA moot.

Lenders can also rely on representations and warranties in loan agreements to ensure proper maintenance of IA. The representations and warranties will generally cover title and legal rights, challenges and infringements, registrations and renewals, prior encumbrances and conflicting third party or contractual interests.

(5) Taking Security

The process of taking security over the IA involves various factors. The starting point is to determine the location and governing law of the IA. Complex conflict of law issues may arise if the IA are multijurisdictional, which is often the case.

Once the governing law is determined, the next step is to decide if there are any legislative requirements involved and the various permitted forms of security over the IA. If possible, specific or statutory security should be taken over the IA. If not, it will be by a generic security arrangement such as a fixed and floating charge which is available in certain jurisdictions.

In some cases, security is also taken over the shares of the company holding the IA. This provides an alternative method of enforcement by way of transferring the shares of the company holding the IA instead of the IA. This method of enforcement is relatively easier as it does not involve the transfer of the IA themselves, but the shares of the company holding the IA. It is also less disruptive to the business and operations of the company. However, the lender will have less control and priority over the IA unless the IA are also secured to the lender.

It is also important to perfect and protect the security over IA. Perfection of security is required to ensure or enhance its legality, validity, enforceability and/or priority. General perfection requirements include registration, notarisation, notification and consent. Protection of security goes towards preserving the integrity and effectiveness of the security. General protection requirements include protection against conflicting third party interests, as well as the right to access, control and transfer of the IA.

For IA subject to foreign securities, lenders have to understand the foreign security laws and concepts, and the foreign procedures and processes involved.

In terms of practical safeguards, lenders should put in place arrangements to facilitate the enforcement of security over IA. Some examples include escrow arrangements, custodian arrangements and powers of attorney. Given the prevalence of the subscription model, another practical factor to consider is whether the lender has access to the subscriber and investor portal. However, there will also be confidentiality and data protection issues if the lender is given such access.

(6) Enforcement

Finally, the enforcement of security taken over IA is essential to realise their value if there is a default on the loan. To this end, the following factors should be considered:

a. Legislations – there may be specific legislations relating to the enforcement of security over IA.
b. Enforcement process – there may be jurisdictional-specific general law and contract-specific enforcement processes for the enforcement of security over IA. For example, there may be a requirement to obtain a court order for enforcement, conduct a public auction instead of a private sale and/or appoint a third party receiver over the IA.
c. Practical safeguards – it may be possible to incorporate practical safeguards to facilitate enforcement such as self-help remedies, powers of attorney, escrow arrangements or custody arrangements. An example is a clean room to hold copies of software, source code, user guides and other materials in a secured location with agreement on access and use.
d. Self-executing IA – certain IA, such as smart contracts, may be self-executing and it is important to determine how this may affect enforcement by the lender. It may also be necessary to consider how the smart contract interacts with the traditional text-based contract in the form of the loan agreement or security document.
e. Time and cost – the costs and time involved in an enforcement should be considered especially in cross border enforcements.

IV. Conclusion

IA form an integral part of the digital economy. They will continue to grow and evolve as more companies embark on digitalisation and digital transformation. The pervasiveness of IA on a global scale and the success of tech companies like Facebook, Amazon, Apple, Netflix and Google (FAANG) demonstrate that IA can bring immense value to businesses. The role of IA has been enhanced even in traditional brick-and-mortar companies, as seen from the development of tokenisation in the real estate industry.

Lenders play a critical financing role in this digital ecosystem. Financing IA in the digital economy presents both opportunities and risks. IA are different from the conventional tangible asset classes familiar to lenders. They are also relatively new and fast evolving. Understanding the IA strategy and the various financing considerations for IA will help lenders capitalise on the opportunities and mitigate the risks in financing IA in the digital economy.

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