



ENPRIS SUBMISSION

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Promoting the Use of IP Assets for Raising Finance by SMEs

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FOREWORD

I was recently asked to provide a valuation of the IP embedded in a company (a spin-off of a well-established SME) for the purpose of raising equity finance. The objectives were to both commercialize the technology and to provide the shareholders with some return on their investment.

The spin-off had outstanding technology ‘defended’ by a granted patent and patents pending, a large market place, existing barriers to entry, pricing advantages and a solid and experienced team in the vertical space.

However, the spin-off had no customers, no route to market and no detailed sales & marketing strategy.

ENPRIS turned down the valuation mandate. Why? Because the reality, in the current environment, is that very few sophisticated investors would put money into an early-stage spin-off purely on the basis of an expert’s opinion of the valuation of the IP. For those few investors that were willing to invest, the pre-money valuation obtained would likely be on the low side and may be unattractive to existing shareholders.

In my experience, financiers want to see evidence of the potential to convert an idea into a commercially viable business, particularly from the pure equity side. They need to see that certain boxes are ticked to establish this potential.

These ‘boxes’ include market size, growth, a sales & marketing strategy, commercial or pilot customers (and/or possibly evidence of a sales pipeline), existing barriers to entry, an experienced management team and so on. Fundamentally they need some proof that the IP assets embedded in a company have the ability to generate income.



Even an angel investor would need to consider ‘who’ has established the IP and their long-term plans for commercializing the IP and crystallizing any shareholder gain (‘how’), over and above the defensive/offensive advantages accruing to the owners of the IP. This ‘how’ requires the use of intangibles assets (“IA”), tangible assets and liabilities (for instance, funding or suppliers).

However, it is clear that IP plays an important role in commercialization of a product(s) and the funding of an enterprise whose role is to commercialize the product(s), whether the financing is obtained from an equity or debt perspective.

This Submission (“ENPRIS Submission” or “Submission”) provides a brief analysis on the current status of the role of IP in raising finance and submits various recommendations for the Policymaker, SME, Financier and Advisor on increasing and promoting the use of IP assets for raising finance by SMEs.

For the purpose of this Submission, Intellectual Property assets include patents, trademarks, designs, copyright and know-how.

The ENPRIS Submission is intended solely for use within the framework and objectives of the WIPO Round Table discussions and for SMEs within the context of the objectives of the Round Table.

The reader should not construe this as financial advice nor should they depend on any elements of this Submission in making a decision pertaining to their own individual circumstance. The reader should note that the Author does not warrant the accuracy of any information contained herein and any information contained herein has been provided for educational purposes only. The reader agrees to hold ENPRIS harmless where this Submission is relied upon in any manner. If the reader is not willing to comply with the statements above, or where any doubt exists, the reader should delete this Submission and any copies immediately. Where, by jurisdiction, this Submission contravenes any of the laws or self-regulatory restrictions imposed under that jurisdiction, the reader should delete this Submission and any copies immediately.

ENPRIS RECOMMENDATIONS

This Submission, aimed at Promoting the Use of IP Assets for Raising Finance by SMEs, recommends (the “Recommendations”) that:

- 1) A centralized IP marketplace, where feasible, is established, endorsed and run under WIPO’s control or supervision for the sale and/or licensing of IP assets on a stand-alone basis, with a view to increasing transparency, price discovery and the liquidity of IP assets.
- 2) SMEs change their traditional mindset and analyse their risk financing objectives from the financier’s perspective. The savvy SME should have a thorough risk mitigation strategy in place in order to provide a competitive advantage when seeking risk finance. Financiers, particularly debt financiers, should provide the educational and functional support that will allow SMEs to conduct this analysis.
- 3) SMEs forgo the ‘blue-sky’ valuations. SMEs should adopt a practical approach to the valuation of their IP within a corporate structure. Sufficient benchmarking information is available within the public forum to conduct this analysis.
- 4) SMEs thoroughly analyse the information available from the private and public equity markets in relation to the role that IP plays in obtaining risk finance.
- 5) Advisors move away from the theoretical valuation of IP and adopt more of a ‘common-sense’ approach.
- 6) Debt financiers consider risk-based IP from both the portfolio perspective and arbitrage perspective, consistent with a wider financial engineering approach.
- 7) Debt financiers should consider broadening the use of IP as a secondary asset, within their own credit structure and within the financial engineering approach mentioned above.
- 8) Programs are undertaken to educate the wider retail investor community on the value of IP.
- 9) Business intelligence tools are utilized to enable more transparency of IP assets from the equity/debt financier’s perspective.
- 10) Policymakers legislate against the current proliferation of pure IP portfolio holding companies, whose primary strategy is that of litigation.
- 11) All parties work towards a level playing field in both litigating and defending against IP infringement claims (from a time and cost basis).

WHAT ROLE DOES IP CURRENTLY PLAY IN RAISING FINANCE FOR SMEs?

What role does the IP Asset play in raising finance from the private and public equity markets?

A raft of information is available from the private and public equity markets on the role of IP in obtaining finance. As already inferred, IP is just one facet involved in the raising of finance from the private and public equity markets.

From the perspective of the private equity investor (using the wider definition), a significant amount of information on angel, venture capitalists and later stage investors is available within the public forum, including detailed information on the kind of investments that the investors consider within the bounds of their investment parameters. The sources of this information are numerous and outside of the bounds of this Submission. However, it is worth noting, given the common misconceptions surrounding the value of IP (predominantly concerning worth), the following venture financing median Pre-money valuations in the US market.

US VC/Private Equity Funded Valuations¹

Table 1 - Median Pre-money Valuations by Round Class (\$M) 2000-2006

ROUND	2000	2001	2002	2003	2004	2005	Q206
Seed	\$5.0	\$3.4	\$2.5	\$2.0	\$1.5	\$2.0	NS ²
First	\$12.2	\$8.0	\$6.0	\$4.6	\$5.6	\$5.4	\$5.6
Second	\$40.0	\$18.0	\$13.0	\$13.0	\$12.4	\$14.0	\$22.8
Later Stage	\$85.7	\$40.0	\$24.0	\$20.0	\$28.0	\$33.1	\$36.8

Table 2 - Median Pre-money Valuations by Development Stage (\$M) 2000-2006

DEVELOPMENT STAGE	2000	2001	2002	2003	2004	2005	Q206
Startup	\$5.3	\$4.6	\$4.3	\$2.6	\$3.0	\$3.3	NS ³
Product Development	\$16.0	\$14.2	\$9.4	\$9.0	\$11.6	\$11.0	\$17.0
Shipping Product	\$39.0	\$19.0	\$12.5	\$10.6	\$13.7	\$18.0	\$27.0
Profitable	\$36.8	\$21.5	\$10.9	\$14.0	\$16.5	\$19.5	\$30.0

This section will detail the role that IP has played in a recent number of SME-related public equity market raisings in Australia, including detail on the valuations obtained and the role of the raising in either commercializing the IP or providing a return for

¹ Source: Dow Jones VentureOne 2006 Venture Capital Industry Report and Dow Jones Financial Information Services.

² Not Significant

³ Not Significant

shareholders. The aim of this analysis is to provide a jurisdictional insight into the role of IP in the primary public equity markets, using the Australian public equity markets as an example.

The analysis has profiled 12 SMEs⁴ that have listed on the Australian Stock Exchange in 2006. The analysis is organized into the following categories:

- Company Code (numbered)
- Industry
- IP discussed in the Offering Document (Prospectus, Information Memorandum, etc). Specifically this includes any references to patents (“P”), copyright (“C”), trademarks (“T”), designs (“D”), confidential know-how (“K”) (a.k.a trade secrets or proprietary information) with an explicit IP-related context.
- Marketing focus on individual IP (Yes (“Y”) or No (“N”)). This refers to the marketing content of the Prospectus and the role that the IP explicitly plays in the marketing of the Offering. This view is subjective.
- Sales revenues (historical - may be on a pro-forma, implied, assumed or annualized basis).
- Post-money valuation⁵ (referenced from the Offering Document).
- Shares issued or sold⁶ (referenced from the Offering Document).
- Percentage (%) of shares issued or sold as a proportion of the Company’s ordinary issued share capital (referenced from the Offering document).

Table 3 - Snapshot: The role of Intellectual Property in Australian SME IPOs^{7 8}

Role of IP in Selected SME IPOs for 2006				
Company	1	2	3	4
Industry	Mining & Exploration	Automotive	Financial Services	Education
IP Discussed in Offering Document	None	P,C,T,K	P,C,T	None
Marketing focus on selected IP	N	N	N	N
Sales Revenues (\$A, historical)	\$0	\$27.3m	\$1.4m	\$7.5m
Post-money	\$5.5m	\$35.1m	\$14.0m	\$16.5m

⁴ Defined for the purpose of this Submission as micro-enterprise to small and medium sized companies with annual sales of up to Euro50m (based on current exchange rates).

⁵ Equity

⁶ Where a minimum subscription is provided, the minimum subscription has generally been utilized. Excludes the effect of dilution from option or hybrid structures.

⁷ Source: Australian Stock Exchange, Australian Securities and Investments Commission, Company websites.

⁸ The reader should note that due to financial and structural differences, this analysis may not be on a comparable or like for like basis, however is suitable for the purpose of this Submission. ENPRIS does not warrant the accuracy of the information.

Valuation				
Shares Issued (I) or Sold (S)	I	I	I	I
% of Shares Issued or Sold	45%	75%	43%	18%
Role of IP in Selected SME IPOs for 2006				
Company	5	6	7	8
Industry	Health Care	Gaming	Exploration Services	IT Services
IP Discussed in Offering Document	None	P,C,T	P,D,K ⁹	None
Marketing focus on selected IP	N	N	Y	N
Sales Revenues (\$A, historical)	\$1.6m	\$42.0m	\$0	\$34.8m
Post-money Valuation	\$11.2m	\$174.6m	\$8.7m	\$131.5m
Shares Issued (I) or Sold (S)	I	I	I	I/S
% of Shares Issued or Sold	16%	40%	26%	I-17% /S-37%
Role of IP in Selected SME IPOs for 2006				
Company	9	10	11	12
Industry	IT&T	Food & Beverage	Mining & Exploration	Consulting Services
IP Discussed in Offering Document	None	P,T	None	C,T,K
Marketing focus on selected IP	N	N	N	N
Sales Revenues (\$A, historical)	\$1.1m	\$2.3m	\$0	\$27.1m
Post-money Valuation	\$9.0m	\$9.2m	\$13.1m	\$137.3m
Shares Issued (I) or Sold (S)	I	I	I	I
% of Shares Issued or Sold	28%	33%	38%	29%

⁹ Offering Document includes a Patent Attorney's Report.

Whilst this analysis is certainly not statistically significant, one can only surmise that separately identified IP does not play a significant role in investors' minds when providing public market finance to SMEs in the Australian market. It should be noted that implicit know-how features throughout these Offering Documents, however this know-how is not generally capable of protection.

Interestingly this analysis would infer that while IP does play some role for SMEs obtaining equity finance from the public markets, the role of IP does not appear to play a significant part from the marketing perspective of the Offering in the company (and business) based on our analysis. Furthermore, no positive correlation between IP and the valuations obtained in the public equity markets is evidenced in this analysis.

This appears to corroborate my view, and certainly that of a number of my peers, that IP plays a major role in obtaining finance for SMEs, but that the IP, at present, can only be effectively leveraged via the use of other assets and liabilities.

The analysis, while based on a small sample, illustrates a potential disjoint between the equity investor in the private markets and the equity investor in the public markets and leads to an interesting point of potential debate - is IP over-emphasized in the decision making process of the investor in the private markets or under-emphasized in the decision making process of the investor in the public markets, or do the markets purely shift their focus from IP to the role of intangible assets, tangible assets and liabilities as the company enters the public markets? Apparent from this analysis is the fact that pre-revenue or limited revenue companies are able to raise finance in both markets, private and public; however there seems to be a fundamental difference in approach regarding the perception of IP as a significant value-adding feature.

This leads to the Recommendations of this Submission. Accordingly, consistent with the Recommendations:

The SME needs to:

- a) Be realistic about the valuations that can be obtained for an IP driven company, and therefore the IP itself, understanding that the public and private markets operate, on occasion, independently of each other from the valuation perspective and that other assets and liabilities play a significant role in the crystallization of value.
- b) Have a thorough risk mitigation strategy in place in order to provide a competitive advantage when seeking risk finance. While not discussed directly in the analysis above, these Offering Documents (consistent with other jurisdictions) devote a significant amount of focus on the area of risk identification and mitigation.



Financiers need to:

- a) Provide the educational and functional support that will allow SMEs to conduct risk financing analysis from the financier's perspective.

Advisors need to:

- a) Move away from the theoretical valuation of IP and adopt more of a 'common-sense' approach.



What role does the IP Asset play in obtaining debt financing?

For the purpose of the Round Table, this Submission will only summarize several of the issues pertaining to the role of the IP Asset in obtaining debt financing.

This section will detail the role that IP has played in obtaining debt financing in Australia.

The atypical lender will typically focus on two aspects of a Company (including an IP driven Company):

- 1) Cash Flows, and;
- 2) Security

Consistent with the section above on equity financing, IP plays a role (qualitatively) in the ability to raise debt financing, however the emphasis on intangible assets and tangible assets plays a far more significant role from both the primary (cash flows) and secondary (security) perspective. Security has traditionally taken the form of a tangible and/or a liquid asset(s); however the IP asset is traditionally not recognized as security in the Australian market.

From a cash flow structuring perspective, the factoring market has developed in Australia, but is focussed predominantly on customer/trade receivables (including the administrative function). The securitization market in IP has not developed for a variety of factors, with an absence of notably creative transactions such as the copyright-generated Bowie Bonds, the Guess?, Inc trademark securitization and the Yale University patent securitization. The reader should note that these securitization structures were generated from licensing revenues, reiterating the fact that IP in itself is typically commercialized utilizing a base of related assets and liabilities.

From a more generic perspective, the typical amortizing or bullet-type loan structure continues to revolve around traditional cash flow analysis and traditional forms of security. Very few lenders, if any, will lend on the basis of IP unless the IP is embedded in the company structure and the company has been equity financed/sponsored.

The leveraged buyout/transaction market in Australia, for instance, may provide 60-70% debt for selected transactions, but typically the lender will look at the transaction from an interest coverage (again relating to cash flow), security and volatility perspective. Where there is any unsecured element (not forgetting the ranking of creditors over shareholders), it will typically act as a subordinate tranche and the risk margin will be priced in accordingly. Typically, this kind of structure is only available



to the higher end of the SME market, with the IP of the business only one element in obtaining finance.

Finally, from a sensibility perspective, the debt financier obtaining say, LIBOR plus 300-700 basis points on an SME transaction will generally not be adequately compensated for the risk associated with the IP Asset (on a stand-alone basis). Any widening in the spread would push the cost of debt finance to that of equity, mitigating a number of benefits in using debt as a financing instrument.

This section has quickly summarized some of the contemporaneous issues involved the use of IP assets in raising debt finance.

Looking forward, the use of the IP asset in raising debt finance should increase as the pricing, liquidity, risk and security elements evolve in a competitive market.

This leads to the Recommendations of this Submission. Accordingly, consistent with the Recommendations:

The SME needs to:

- a) Be realistic about the availability and pricing of debt financing that can be obtained where IP plays a role in generating cash flows and providing security for the lender.
- b) Consistent with the equity finance framework, be prepared to enter into a thorough risk mitigation strategy in order to provide a competitive advantage when seeking risk finance.

The Debt Financier needs to:

- a) Provide the educational and functional support that will allow SMEs to conduct analysis from the risk financing perspective.
- b) Provide more transparency on the credit signoff process and greater alignment with the sales (front office) function.
- c) Be more willing to analyse and understand the role and structure of the IP asset in providing debt financing, be this from the cash flow perspective (for instance, use-based licensing) or security perspective (resale perspective), and extend this analysis to a portfolio or arbitrage based approach



POLICY

Finally, Policy plays a key role in the utilization of the IP Asset in obtaining equity or debt finance. The centralization and development, for instance, of a liquid and transparent market for the trading of IP, would alleviate a number of risk, security, pricing and value concerns that currently undermine the role of the IP asset in raising finance by SMEs.

The ENPRIS Submission recommends that:

- a) A centralized IP marketplace, where feasible, is established, endorsed and run under WIPO's control or supervision for the sale and/or licensing of IP assets on a stand-alone basis, with a view to increasing transparency, price discovery and the liquidity of IP assets.
- b) Programs are undertaken to educate the wider retail investor community on the value of IP.
- c) Business intelligence tools are utilized to enable more transparency of IP assets from the equity/debt financier's perspective.
- d) Policymakers legislate against the current proliferation of pure IP portfolio holding companies, whose primary strategy is that of litigation.
- e) All parties work towards a level playing field in both litigating and defending against IP infringement claims (from a time and cost basis).