Opportunities bring innovation and finance together

There has never been a better time for banks and other investors to get involved in the European innovation marketplace. The structures and the tools are there. All that is lacking is the strategy

By **Giancarlo Migliori**

At the IP Business Congress held in Amsterdam in late June we heard many leading IP specialist say two things. The first was: "Innovation, rather than just IP, should be the real game." The second was: "Finance should commit more to this sector." Both statements were correct. The issue is how to develop a strategy that will allow for much closer integration between these two essential service-sector areas.

Close and yet so far...

We have heard for years that major banks were finally entering IP in a big way and that well-known venture capital or private equity funds would truly boost the IP sector. But it was not really true. And this is despite the fact that technological innovation is an ideal channel for those big banks forever trying to capture extra market share or to bring out new fancy products; just as it is for those big investment funds prowling for more deals to utilise the huge resources accumulated in recent fat years.

Innovation is ideal for such expansion and dealmaking, given that at all levels – from supranational to national to regional to local to single company or institution – it is puts at the top of so many business strategies; and that it is becoming a key management area. So why is it not happening? Why are major banks not opening strong IP departments or packaging complex ranges of products the way they do with other, often less attractive, assets?

If we return to the opening remarks of this article taken from Amsterdam, a possible explanation might lie with the dominant first-phase growth in the IP market. This has been US-dominated and, so far, IP-only dominated.

There is no doubt that the IP business has two different drivers:

- The high price attraction of IP which dominates in US markets and is related to enforcement and litigation (leading to speculation).
- The fundamental role of innovation for industrial production and competitiveness which dominates European markets (leading to a robust public sector presence).

So long as the first approach rules, outside operators, including those in the financial sector, will continue to see IP as an odd asset – essentially legal, too technical and unpredictable, good for single opportunities but to be excluded from a range of systematically tradeable or bankable assets.

This will limit the involvement of investors and lenders to:

- Single deals (which may be large like the US$1.8 billion Sears IP securitisation).
- Speculative or opportunistic funds (which may be large, in the billion dollar-plus range).
- The private sector.

This way, IP is not going to be an asset readily analysed and accepted by the entire financial sector, which is what corporates, institutions and IP companies want to happen because only this will ensure permanent growth in volumes and values, as well as the permanent strategic relevance needed to secure backing by public-sector institutions. After all, let us not forget that in continental Europe, the private sector invests too little in R&D, which makes EU and other public-sector funding an absolute necessity.

What banks are doing at present

There are several services that the banks in Europe have so far developed around innovation.

The most significant one concerns research and development lending for reasons directly related to the above-mentioned flows of grants and subsidies from EU programmes. For examples, some banks have entire teams or departments (often based directly in Brussels) servicing corporate customers in their need to submit and service requests for EU or EU-linked funding.

Other more dedicated banks, mostly publicly owned regional development banks plus some private ones, are trying to reduce technology assessment risk by associating with top universities who do the validation, both for their own spin-offs and for the banks' own deals. These alliances have not worked well, as the academic sources themselves lack new and better methods for valuing IP. They also have old-fashioned or non-profit ways of handling business dealings.

A very small number of banks have ventured, usually through specialist IP partners, into investing directly through funds specialised in technology start-up or even IP start-up risks. The amounts in question are, for the time being, far smaller than similar projects in the US. But it is a start and is a potentially significant model, particularly for regional development banks.

What banks could be doing

Accounting and legal authorities are focusing on IP as a key intangible asset and that includes bodies such as banking associations and financial analysts associations. So what can we do to ensure that this positive momentum turns into a larger commitment from banks?

First, we need to integrate technology (an asset well known and liked by finance because it is something that represents a proven innovation) and IP (the little-known, unproven, upstream item that underpins most new technology). And we need to call this combined product innovation.

Second, we have to publicise the fact that innovation has now achieved the key elements required to attract banks into regular dealing. These are:

- Abundant supply.
- Abundant and wide-based demand.
- Efficient marketing/packaging/trading.
- A calculable benchmark/risk.
- A regulatory framework.

There may be doubts over which benchmark to use, whether it be Ocean Tomo's IPQ or other volume ratings, but it is a fact that some of these methods already have official financial authority approval, to the point of being quoted on major exchanges. That is what financial operators need before internal acceptance for dynamic trading purposes. Thus, we can argue convincingly with banks, at least for all US patents and IP, that a market exists and is ready to be developed.

Third, we must structure a range of services the same way banks organise theirs – something which, incidentally, is also the best method for attracting European demand

Chart 1. **Example of innovation merchant banking services**

Day-to-day management of technology and IP assets	
Market readiness – base products	• Qualitative assessment (from single to entire portfolio) • Due diligence (feasibility analysis and market prospects) • Portfolio audit (positioning and relevance of tech and IP portfolios)
Market activity – commercialisation, trading and value creation	• Corporate finance advisory • Private sales (buy/sell of IP in one-to-one negotiations) • Open sales (local, national, international IP auctions and tenders) • Licensing & trading (generic/selective, open/proprietary, etc)
Deal-related management of technology and IP assets	
Corporate finance	• Specialist technology & IP operations of lending, M&A, JV, venture capital, sale and leaseback, asset-backed finance etc
Alternative market – asset management & investment products	• Active strategy: enhanced competitive positioning (via purchase of financial instruments based on IP) • Passive strategy: hedge or defence strategy through benchmarking (via purchase of financial instruments based on IP)

Chart 2. **Impact of innovation on European enterprises**

	Normal cos	**Innovative cos**
Average EBIT	3.5%	9%
Turnover from new products	Factor of 1	Factor of 1.5 = +50% revenue for innovators
Time to market of products	Factor of 1	Factor of 0.5 = +100% more efficient in the market
Owner patents	Factor of 1	Factor of 5 = +500% more: a. control of own assets b. barriers to competitors c. strength of brand
Cost of R&D	Factor of 1	Factor of 1.5 = +50% costs (NB against 500% more control)

Such impressive improvements in financial performance, industrial production and market positioning reduce investment risks and attract banks to innovative companies and assets.

Source: *Data from a pan-European study commisioned to ATKearney by Confindustria*

(SMEs, large corporations, private investors and public sector agencies) into dealing dynamically and regularly.

In Chart 1 is an example of merchant banking services. It is used in Italy by my own company. We market in two versions: one more complete and complex for larger clients; the other simpler for SMEs. This structure satisfies the key needs of EU corporate demand, which are:

- Market readiness – valuation, mapping and competitive positioning.
- Market activity – trading, commercialisation, licensing.
- Market investments - corporate banking services.

The IP market already offers all of these tools in a variety of forms – from low-cost to customised, tip-top packaging.

Structural progress achieved and innovation finance of the future

It is important to underline specific progress that has already been made in solving arguably the most serious obstacle to European technology and innovation: the absence of start-up and early stage financing. This is now easier to deal with for European banks through two key areas:

- Valuation, analytics, mapping and competitive positioning. These current techniques, highly requested by SMEs and blue-chips alike, allow banks to assess the technological status of their client or prospective borrower, thereby reducing risks in the prospected transaction/s.
- Risk management, where the spreading of low-cost innovation valuation (ie, IP) reduces investment risks for both banks and VC funds by helping to bridge the notorious financing gap.

Added to these is the focus of the European Commission, which has an EU-wide programme of education and training called Pro-Inno Europe.

Possible future scenarios

The EU has ratified its seven-year R&D programme starting in 2008. This sets in motion over Euros 100 billion in public funding. It is a formidable opportunity.

Innovation merchant banking structures as in Chart 1 have already had a positive effect on these global and regional institutions. It has done so by promoting growth, international expansion and competitiveness through several of the services in that dynamic next-generation model. This favourable timing and positive role for banks should lead to various new opportunties.

Large commercial banks, which are studying intangibles for Basel II, for example, should now be actively considering the following options:

- Wider use of existing IP valuation models (especially large-scale, low-cost ones).
- The expansion of SME banking departments to include more innovation projects plus products plus processes.
- An increase in lending plus leasing based on innovation assets done directly and together with the global (EU) or regional public sector.

Chart 3. **Professional investors have reasons to focus on innovation**

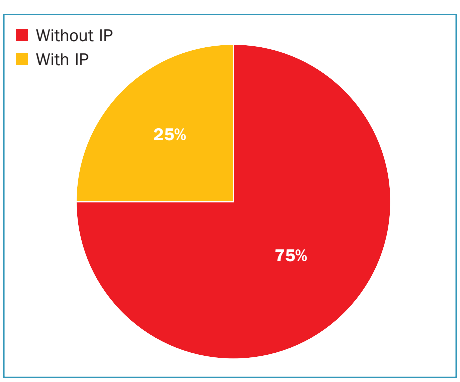
Examples of significant recent operations involving innovation (tech+IP):

- 1st quoted index (Amex) based on IP portfolios of 300 US Stock (OT 300 Index).
- Large US and European banks create funds to invest and trade in IP.
- Various private equity funds and hedge funds invest in IP and technology.
- Ocean Tomo planning first large multiple strategy fund applied to US and EU IP.
- IPX: strong initial support for first global IP exchange to be created in Chicago.

Source: *John Marshall Law School US. IP Marketplace, Past, Present and Future, study by James Malackowski*

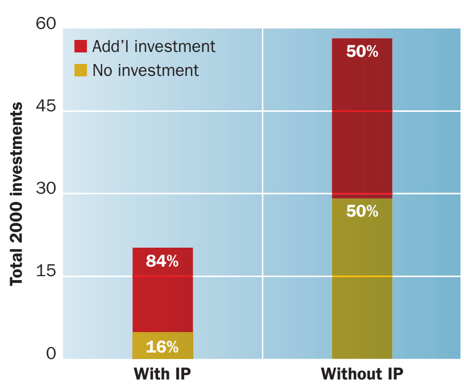
US study on 2000 start-up/seed/early stage investments by primary VC funds

Venture capital investments by type



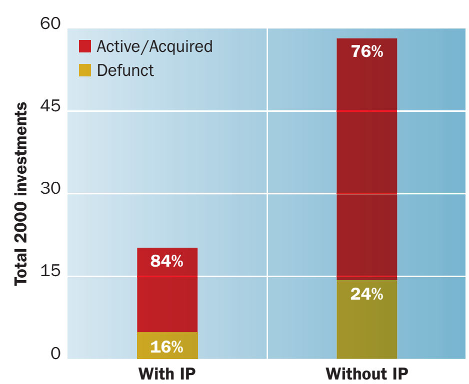
Investments: top VC funds invested 25% of their resources in companies with good IP

Venture capital with additional funding



Funding: only 50% of companies got second round credit without good IP, against 84% with good patents

Venture capital investments by status



Results: 24% of projects without good IP failed, against only 16% with good patents

- Setting up innovation trading departments, akin to other OTCs, using IP valuation models as above, in anticipation of larger volumes appearing as a result of official exchanges like IPX in the US or national ones being studied in the EU.

For merchant banks possible options include:

- The wider use of existing IP valuation models (especially large-scale, low-cost ones).
- The expansion of cross-border M&A activity focused on technology or tech-impacted deals (currently a very active sector involves EU-to-US deals due to dollar weakness).
- The insertion of innovation assets into asset management product ranges.

For their part, investment funds need to be thinking about:

- The wider use of existing IP valuation models (especially large-scale, low-cost ones).
- Setting-up targeted innovation funds – wholly owned or in JV with regional public-sector bodies – with mandates to invest partly in early stage technology companies (as is done at present) and also partly further upstream in IP (mostly patents).

The true breakthrough player

The involvement of large commercial banks, merchant banks or investment funds in the ways set out above will significantly increase innovation activity and would be welcome developments. But an even better solution would be a global player, represented by a bank with internal or external IP capability, enjoying the support of institutions (public and private), leading to the creation of an innovation bank or finance company dedicated to the development of a national or regional territory.

Such an entity would be able to display the full range of services described in Chart 1, supported by the enormous public funds available to R&D but currently not extended to IP. In addition, this operator would be able to capture the major projects going on all over Europe – including the London Olympics and the Milan Expò – the values of which recent studies have calculated to be 40% to 60% driven by innovation. In Italy, for example, over the next seven years there will be almost Euros 100 billion linked or driven by innovation projects. The same thing is going on in other EU markets as well.

The time is right

The cultural and profit barriers which have historically kept IP away from mainsteam finance are now largely overcome. The new techniques described in this article, and others in the marketplace, allow banks and investors to increase their commitment to innovation, both upstream (IP) and downstream (technology). The timing is good, thanks to both structural drivers – as in the box to the right – and massive market opportunities.

Specialist innovation services companies growing around Europe should increase their pursuit of dynamic banking and institutional partners to ensure that this good timing and the opportunities are not missed. They should do it for the sake of their own success, but also for the health of our industrial systems. These are being squeezed by aggressive competition and are in need of increasing flows of external innovation to add to and replace the old in-house-only method.

European companies must have an innovation strategy

Irreversible changes are taking place which make a proactive tech & IP strategy inevitable for supply (R&D world) and demand (industrial companies).

Strategic driver: impact of intangibles on the value of balance sheets. Intangible assets have become the primary economic value and a new asset class. Technology and IP are the main intangible assets for companies.

Industrial driver: technology and IP are the number one competitive factor. Where there is a competitive gap, countries as well as companies are obliged to look at tech & IP flows as key to improving exports and product/process innovation.

Legal driver: more incisive courts and more aggressive owners/speculators are leading to the development of technology strategies before, not after, products go to market in order to avoid copying and litigation. It is the end of the bad habit of first going to market, then (perhaps) patenting!

Administrative driver: by 2010 intangible assets in balance sheets (IASB). International accounting boards are moving to ensure EU companies insert intangibles in their accounts "even when not negotiated in active markets". First among them: technology & IP.

Financial driver: innovation and technology improve profit and productivity. Banks, funds and investors prefer projects and risks which include IP and technology.

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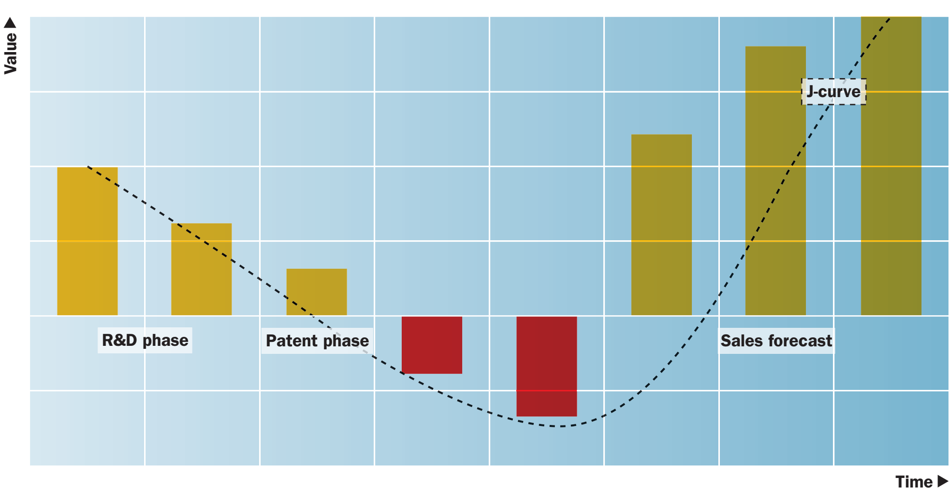
Chart 4. **Venture capital: neutral valuation of IP reduces start-up risks**



Financing gap – upstream phase financing: from tests to prototypes to selection of winning projects.

Europe's true "competitive gap" with the US.

Facilitating the intervention of banks or VCs in this phase would be the breakthrough for European innovation.