GETTING A GRIP ON INTANGIBLES

ESZTER KONTOR AND **JUDY DAY** TACKLE THE ISSUES AND CHALLENGES FOR COMMERCIAL LENDERS CREATED BY THE INCREASING IMPORTANCE OF AND RELIANCE ON SOFT ASSETS OR INTANGIBLES.

That intangible assets contribute to the profitability of the company and therefore have a value for the firm is not a new notion. We are all aware that certain industries such as the pharmaceutical industry or the entertainment sector rely heavily on such 'soft' assets. What is new is the growth in the proportion and importance of these soft assets in almost all industries, and the emergence of new industries in which most, if not all, of the profit-making ability of the firm lies there.

The effects of this change on commercial lending are many and various, and may therefore not be capable of full analysis, but clearly there are important implications for both lenders and borrowers. Without adapting lending practices to this new feature of the economy, a significant segment of the market might be lost for banks. On the other hand, borrowers who are unable to convince lenders of the strength and value of their intangibles-based business may be able to raise funds only on relatively unfavourable terms. Therefore, it is in the interest of both sides to work at ways of adapting standard contractual mechanisms.

PRACTICAL PROBLEMS. Lending practices, procedures and documents are a reflection of managers', lawyers' and accountants' often divergent understanding of the term 'intangibles'. Corporate borrowers see intangibles as part of a wider perspective, which has the ultimate goal of effective and profitable management of the company's business. From a legal standpoint, the question is whether 'things' that are regarded as intangibles by a businessman are capable of being recognised as separate items of property to which rights and obligations are attached. Whereas ideas and knowledge are numerous, they exist for a lawyer only if they have gained the recognition and protection of the law.

Secondly, when the law does recognise such items, it also defines which interests and rights can be attached to them – for example, whether they can be given as security. One implication of this is that the number of legally defined intellectual property rights held by the company is likely to be more narrowly specified at law than the many factors that may create value for the company.

UK accountants employ a traditional historic cost-based method and their approach to intangibles is best described as inclusive. Starting with separable assets such as trademarks or patents at one end of the spectrum, accountants also treat as intangible assets different groups of capitalised costs, such as development costs. Accountants have found it difficult to define specific criteria under which costs incurred by a business may be separated out and individually identified as an asset. Legal recognition of something as a piece of property may facilitate the separation of costs related to it. However, the fact the law treats something as a piece of intangible property does not automatically mean it is an intangible asset to an accountant (for example, debts), and the capitalisation of a collection of costs as an intangible asset may not necessarily rely on the separate legal recognition of a piece of property, but rather on the separate existence of such a thing in economic reality (for instance, a project in the case of development costs). Therefore, under the present UK accounting framework significant assets that are undoubtedly considered by management as value providers for the company are often excluded from the company's balance sheet. Costs related to intangibles that are not capitalised and included on the balance sheet are expensed as incurred in the profit and loss account.

POSSIBLE SOLUTIONS. In a 'gone concern' or 'asset-based lending' situation, the lender's monitoring activity tends to focus on specific assets. Therefore, the treatment of intangibles, their recognition by the law, the rights that may be attached to them and the ability to capitalise costs attached to them have special importance. The lender's concerns in such situations are that the company retains the relevant assets and possibly that it provides them as security and that they do not lose or change their value prior to full repayment.

It might be argued, however, that there is no need to link loan repayment coverage to specific intangibles but that what matters is that the company as an operating whole is in a healthy state and can generate sufficient funds for the repayment of the loan. The 'going concern' or 'cash-flow based lending' approach, in other words, revolves round the perspective that the lender's primary interest is in the performance of the business as a whole, with special emphasis on its earnings activities and cashflows. Therefore, the lender's focus is not on the existence of particular assets, but rather on the application of the assets, which enables the borrower to remain a viable business capable of generating sufficient cash to repay the loan.

We would therefore suggest that, in a situation where the borrower's operations rely significantly on intangible resources, a primarily cashflow-based approach is probably more suitable and feasible for lenders' primary purposes, while not ruling out careful consideration of the availability of security. The application of a cashflow-based lending approach usually means lenders will wish to make use of ratios that can directly or indirectly provide information about the earnings activities and cash movements of the company.

Ratios that provide a direct signal would need to be based on pure cashflow numbers, such as cashflow to interest payments, cash-to-debt or minimum cash balance. More common alternatives to directly cashflow-based ratios include those that (for a particular company's circumstances) are considered to be good indicators of cash movements but are not directly based on primary cashflow data. Therefore, Ebitda or Ebita (earnings before interest, taxes (depreciation) and amortisation) is an increasingly widely used figure in financial covenants. Again, it might be used in a ratio comparing it with interest or with debt, or the covenant may require a minimum level to be maintained.

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However, though financial covenants may be capable of signalling changes in the intangible resources of the borrower, there may be some delay. They may show adverse developments only when changes in intangibles are already affecting the financial status of the company and hence these effects are recorded in the accounts. To overcome this difficulty, lenders need to look for the inclusion of non-financial covenants in the loan agreement. Covenants containing non-financial data are common in some industries. For example, passenger load factor is typically used in airline loan agreements and purchased power to revenues in the case of utility companies. Similar covenants might be developed based on the key characteristics of the particular intangibles of the company. As an example, for some businesses licences or concessions are essential for the supply of services. Hence, the number or market coverage of licences can be very informative data for monitoring purposes.

To be able to design and set covenants lenders need not only a detailed knowledge of the industry in which the borrower operates, but also a good understanding of the borrower's business, including an understanding of the intangible assets that are generating earnings. Clearly the best source of this latter information is the borrower itself. Therefore, provision of detailed information on the nature and characteristics of the company's intangibles is a key tool with which treasurers can facilitate and, to a certain extent, lead loan negotiations.

OTHER ISSUES. Borrowers may do their best to provide relevant information about the company's intangibles, yet it is common in most situations for bankers to insist on including a catch-all clause that can capture unspecified adverse changes in the borrower's business: the 'material adverse change' clause. Despite its pervasive use, it is generally acknowledged that the clause's potentially wide scope and inherent vagueness can lead to uncertainty for lenders and borrowers. Although the clause's primary aim is to provide the lender with a last resort in situations of significant deterioration of the business that require immediate action and are not captured by other covenants, borrowers face the possibility that banks could invoke the clause essentially as a lever to initiate renegotiation. However, if lenders rely on this clause to declare an event of default, then they face the risk that the 'adverse change' or its 'material' nature cannot be demonstrated – which is arguably more likely in cases where unspecified or ill-defined intangibles are involved – and so they may be held liable for damages suffered by the borrower. If the borrower's other loans are linked by a cross-default clause, then damages could be significant. Overall, we would argue in favour of avoiding the inclusion of this clause where possible and suggest the inclusion of more specific covenants as discussed above.

This strategy relies on the maintenance of information flows between lender and borrower – as is true for most lending situations. However, data on intangibles is not easy to identify and include among the information typically required as a part of published accounts, for reasons discussed above. Some companies have attempted to prepare an intellectual capital report or similar, which looks at the knowledge base of their operations in parallel to their regularly provided financial reports.

Another reason for the separation of the two reports is that the intellectual capital report includes non-financial data on intangibles. A further possible source of information could be the Operating and Financial Review (OFR). The Company Law Steering Group has recently proposed that information on the intellectual capital and other intangibles of companies might eventually be included among the mandatory items of the OFR. An advantage of the OFR could be that it is not only a report on the 'soft' assets of the company, but that it also appears to a certain extent in a standardised form. Therefore, the bank may be able to obtain comparable and possibly audited information on such assets.

STRATEGIES. The increased importance of intangible assets for such a wide range of businesses worldwide is a relatively recent phenomenon, thus our understanding of the features of intangible resources lacks clarity as yet. This creates difficulties for both lenders and borrowers. Treasurers of these knowledge-rich companies need not only to understand the nature of their company's intangibles but also to develop strategies with which they can demonstrate to their lenders the strength and value of these so-called 'soft' assets. On the other hand, lenders also need to consider the structure and design of their monitoring tools and ways of improving the credit assessment of intangibles-based businesses.

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