Written by
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IP bonds 2.0

The largest ever IP backed securitisation, US$1.8 billion for Sears' Kenmore, Craftsman and DieHard brands, may be a harbinger of things to come for IP as an asset class and for financial markets flush with capital

A new generation of IP bonds has been born. These bear only a passing resemblance to the royalty backed Bowie bonds which were issued in 1997. That instrument relied on a stream of projected income from copyrighted songs to make the lender whole. My understanding is that Sears' brand-name bonds do not involve any pre-existing royalty payments.

Contrary to popular belief, monetising IP is not alchemy. Properly structured, IP financings can unlock value that markets and capital providers have overlooked. But while interest in IP assets is healthy, too much capital chasing the wrong rights is not. It's up to the financial markets to divine the logic of this transaction, but my money is on Sears' reputation for dependability.

The story broke in *Business Week* in the middle of April and much of the press picked up on how Sears "quietly created" the mechanism for transforming its Kenmore, Craftsman and Die Hard brands into a financial security. Eric Hedman, an analyst at S&P, which like *Business Week* is owned by McGraw-Hill, called it the largest IP loan ever.

Wide impact

The structure and intent of these bonds are worth examining. This transaction affects every large IP owner and investor, especially stakeholders in innovative companies.

It has been widely reported that Sears Holdings Corp (NYSE:SHLD) CEO Edward Lambert wants to recast its floundering retailing giants Sears and Kmart in the image of Warren Buffet's valued-laden Berkshire Hathaway. But what has actually happened?

The bonds, as I understand them, did not leave control of the company. They are being held in Sears' Bermuda-based insurance subsidiary. According to *Business Week*, Sears first created KCD, a "separate, wholly owned, bankruptcy-remote subsidiary" (sometimes known as a special purpose entity or IP holding company). This is not at all unique and many significant IP holders establish SPEs primarily for tax purposes, but also to control operating company cash flows and profit. KCD issued the bonds that are being held by the Bermuda insurer. Sears is licensing the brands from its own sub, presumably to provide the Bermuda entity with assets but not income because Sears pays no royalties.

With a stronger balance sheet than Sears Holdings', the Bermuda insurer which it controls, or KCD, is in position to engage in financial engineering that could benefit the operating company. (The bonds are worth more on the sub's balance sheet than on Sears'). In fact, the KCD bonds are rated by Moody's Investor Service four rungs better than Sears' junk debt. Through KCD, Sears can issue debt and use the funds to acquire an insurer or for other leverage. For Sears equity holders, this creates opportunity; for its secured debt holders, the re-capitalisation is less positive. They can no longer rely upon the company's crown jewel assets in the event of a bankruptcy. But, then again, in that scenario those assets are not likely to be valued at US$1.8 billion.

Why do it then? Todd Sullivan, editor of Seeking Alpha, an investment blog (http://retail.seekingalpha.com/article/31960\) responds thoughtfully to that question:

> *1. Sell the bonds to outsiders. Then, Sears would be holding up to $1.8 billion in cash, and investors would be holding the bonds.*
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> *2. License the brands: Many people [Sullivan included] feel there is a huge revenue stream for Sears in the value of these brands. Allowing outside manufacturers to make products and use the Craftsman, Kenmore and Diehard brand names in return for royalty payments is an easy way to increase profits without any additional expense. These payments would be virtually 100% profit for Sears.*
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> *3. Swap bonds for debt. Lampert acquired K Mart through its debt. These new "brand" bonds allow him a vehicle to do a similar deal. How? Lampert could swap these bonds or a portion of them for the debt of another company. One morning a shareholder of BJ's could wake up and find that Sears Holdings owns all his or her debt... Having these bonds as leverage also allows for the possibility of a much larger acquisition.*
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> *4. Insurance. Now we have an insurance subsidiary of Sears sitting there holding $1.8 billion in bonds that could be used for an acquisition... few acquisitions would make the stock price of SHLD explode to the upside more than the purchasing of an insurer.*

New era

However Sears chooses to deploy the assets resulting from capitalising its leading brands, one thing is certain: under-leveraged IP rights have entered a new era.

The investment community has come a long way since the appearance of music royalty bonds. While much attention was heaped on these early IP instruments, some of their cash flow projections proved overly zealous in the face of technological advances, such as the iPod. Not faring much better was the securitisation of patent royalties from Bristol-Myer's Squibb's HIV drug Zerit, invented by Yale university researchers. The Sears bonds represent a major step forward for IP not only because of their size, but because of their structure and apparent flexibility. They not only capitalise otherwise underutilised intangible assets, poorly reflected on the company's balance sheet, but could provide the beleaguered company additional resources that can make it more competitive.

I believe the Sears transaction also is significant for certain strategic invention rights, namely patents. While patents without royalty streams are harder to value than marks, lenders are starting to become comfortable with them. If the rights to unlicensed brands are credit-worthy, patents or families of patents that make companies more competitive will eventually be recognised, too. Time will tell.

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