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Intangible opportunities

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About 80 per cent of most companies' value is intangible but many, especially SMEs, do not realise it

In this era of financial constraints and tight fiscal lending raising finance is proving harder than ever, especially for small and medium-sized businesses.

Private backers can be hard to come by and demand equity stakes. Banks are lending less, charging higher rates and being more stringent with their lending requirements, demanding more security. The problem is that many companies do not have valuable tangible assets and those that do are likely to have existing covenants restricting their use, such as a mortgage on a property, security over plant and machinery or factoring on invoices. An innovative solution for IFAs to put to their clients is available through the marriage of intellectual property and a company's pension fund.

A company's intellectual property can be, ironically, its most valuable asset. Intellectual property has not been seen traditionally from an investment perspective as often as it should. Intellectual property refers to legal rights such as copyright, patents, trademarks, designs, know-how, contracts and client databases. Some of these, such as patents, trademarks and designs, are registrable with the relevant authorities providing the owner – or those the owner grants authorisation to - with exclusive right to use and exploit the protected right. intellectual property rights that are incapable of registration will automatically be owned by the creator, who will likewise have the monopoly right to exploit them.

The legal protection of intellectual property rights is similar to property law concepts. As such, intellectual property rights can be assigned or licensed as any other form of physical property can be, making them valuable income-generating assets.

Suitability of pension funds

Because of these financial constraints it is no great surprise that innovative ways are being sought to source new money. Pension schemes have perhaps been something of an untapped resource for many reasons but perhaps most poignantly because of Robert Maxwell's abuse and fraud of the early 1990s.

So where does intellectual property stand in this arena? Can an employer sell its intellectual property to its pension scheme and if so, what are the issues involved? The short answer is yes. Pension schemes can purchase intellectual property as long as the purchase price is at an arm's length market value and the scheme has the power to do so.

Most occupational schemes in the UK are run under trust. That means the appointed trustees – which can include company directors – must run the scheme in the interests of the beneficiaries. They also have the ability to invest the scheme assets as if they owned them outright themselves. This power of investment extends to intellectual property.

The trustee must satisfy themselves that the investment in intellectual property meets the 'prudent man' test, avoiding "all investments attended with hazard". As such, the valuation of the intellectual property is critical. The first task is to identify what intellectual property is to be transferred. A company's 'brand' is made up of many different components. A fashion brand may include its trademark but also copyright and design rights associated with its products, it may also have patents protecting a production capability and contracts for distribution or manufacturer. To maintain and enhance value, the correct bundle of assets must be identified and then valued and assigned collectively.

The valuation process also informs the rate at which the intellectual property is licensed back to the sponsor company from the pension fund, which owns the asset. This is carried out on a commercial, arm's length basis using an applicable royalty rate – following normal licensing conventions. Royalty payments are deducted from corporation tax creating the added bonus of being tax efficient.

Brand and other intellectual property valuation methodologies follow a similar process to valuing tangible assets. The income approach calculates the discounted cashflow value of the economic income generated by the intellectual property over its useful life. Comparable transactions and values are analysed and adjusted for parity with a consideration also taken of the costs of recreating the asset and the amount invested in its creation. These methodologies comply with standards issue by bodies including the International Organisation for Standardization, International Accounting Standards Board and International Valuations Standards Committee.

Investment acceptance

As with all new initiatives, precedent helps ease the process. The Pensions Regulator has for a while accepted tangible assets for pension fund investment and has more recently accepted less traditional assets including many different forms of intellectual property. In December last year, Interserve used PFI contacts, in March 2010 ITV used shares in its broadcaster SDN, in April 2010 engineering firm GKN used a mixed of assets including its trademark, in July 2010 Diageo used barrels of whisky.

Trustees, as well as satisfying the requirements established by case law, must exercise their investment powers in accordance with the Occupational Pension Schemes (Investment) Regulation 1995. These specify the trustees' criteria for choosing investments and ensuring their diversification. However, there is one significant exclusion from the scope of these requirements: regulation seven of the investment regulations provides that the requirements do not apply to schemes with fewer than 100 members. This is an important exception in the SME end of the market where schemes are likely to be small.

Small self-administered schemes are perhaps the most suitable schemes for this purpose because of their flexibility. Ssas's are occupational pension schemes run under a trust with fewer than 12 members, usually established for the benefit of the business owners and key employees. The trustees are appointed by the beneficiaries – which is quite often just one person, the business owner. They have a duty to act as trustees separate from the business but as long as they consider the needs of the members and secure an asset at fair value on arm's length terms they have usually fulfilled their trustee obligations.

A number of these schemes have happened both for a large listed company and SMEs. One involved valuing a patent, copyright, know-how, design right and trading reputation for an engineering process. The patent was at the heart of the business, without it the business was largely worthless. There was an active market for patents of this type which indicates that value could be realised in the unlikely event of the company going into administration. To create additional comfort for the trustees the valuation was conducted on a conservative basis and the transaction took place for less than its market value. This builds in sufficient headroom into the acquisition to take into account any loss of value that may occur through a distressed position.

Another deal was carried using the trademark of a supplier to the retail industry. The supplier had an established reputation in the industry which was represented by his registered trademark. The valuation included the trademark as well as contracts, supply agreements and customer database which supported its marketability. The supplier was able to continue using its brand and with the injection of funds it could invest to grow the business and manage a short-term liquidity issue.

Many companies are intellectual property rich. About 80 per cent of most companies' value is intangible but many, especially SMEs, do not realise it or find it hard to express and define it. And further still, many who do realise it do not realise their intellectual property can be leveraged in such as way. Innovations such as this can be proposed by IFAs to provide access to cash from a friendly investor while still providing security to the company or individual’s pension scheme. Care and professional advice must be sought when carrying this out but if carried out properly it produces a win-win situation for the business, business owners and wider economy.

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