corporate finance

INTELLECTUAL PROPERTY

The invisible In the last decade the strategic importance of intangible assets

In the last decade the strategic importance of intangible assets has increased, and it is now widely recognised that intangible assets represent more corporate value than tangible assets do, which alters the way debt security needs to be considered.

We recently conducted a study of all companies quoted on the world's top 25 stock markets. This showed that the majority of corporate value is not reflected in conventional balance sheet reporting under the historical cost convention. The study revealed that unreported intangible assets represented 62% of \$31.6 trillion total enterprise value.

Inevitably, the proportion of intangible asset value varied from sector to sector. For example, 91% of global technology company valuations were intangible (98% in the US, driven by the likes of Microsoft and Cisco). However, intangible values represented over 50% of enterprise value in all sectors.

The dominant intangible asset class also varies from industry to industry. In the pharmaceutical sector, the key intellectual property is molecular patents. In the IT industry, it is software rights. In the film industry it is creative copyright, and in consumer goods sectors it is often trademarks or brands.

Under new IFRS the picture will improve slightly. Acquired intangible assets will increasingly appear on balance sheets at cost, although internally generated intangibles and increases in the value of acquired intangibles will remain largely unreported. Attempts have been made to quantify and report some undisclosed intangible assets so that investors and lenders can make better financing decisions, but intangible assets will remain inadequately reported in conventional accounts. This makes clearer, more reliable valuation and disclosure in some other form necessary because intangible assets are increasingly being used as the basis for debt security.

There are three ways to use invisible assets to secure debt. First, finance may be secured with a fixed and floating charge against all the assets of a business including intangibles. Second, finance may be secured against specific intangible assets of an existing business. Third, intangible assets may be transferred into a special purpose vehicle (SPV) to which funds are lent.

All three of these may be as straight loans or, in certain instances, securitised instruments. David Bowie's famous bonds (now, sadly, with only junk bond status) are the best example of securitised intellectual property-backed securities.

In the case of trademarks and brands, there are very strong commercial attractions for the SPV option. For example, best practice brand management now includes the creation of a separate strategic brand management company to hold and manage the brand assets. This formalises the relationship between brand owner (licensor) and brand operator (licensee), whether related or third party.

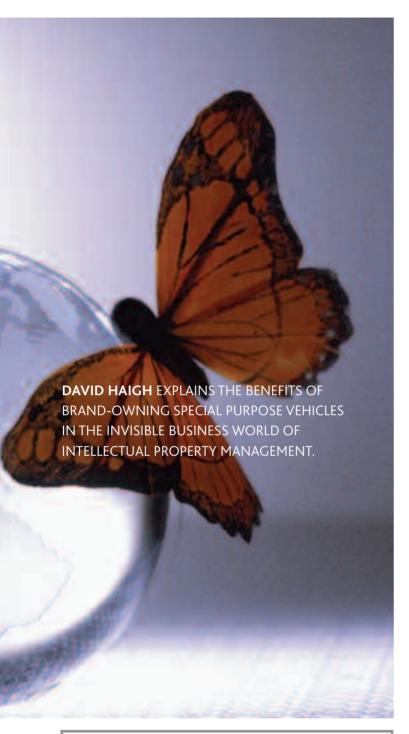
The advantages provided by centralised brand management companies include:

- specialist expertise in brand management, training and facilitation;
- tighter legal controls over the registration and use of trademarks by operating companies and licensees;



- stricter, more unified and consistent control over advertising, design and marketing strategies;
- management of brands as strategic assets rather than tactical resources, enabling more single-minded investments in longer-term brand development;
- cost savings in creative production, market research and media buying;
- extension of brands without reference to operational politics; and
- •licensing of brands more easily into new areas of business.

There are also significant financial and fiscal attractions to the SPV option. Above all an independent valuation of the transferred intellectual property means that the assets in question move from 'off



Executive summary

- Most corporate value is not reflected in the conventional balance sheet, although the picture will improve slightly under new IFRS.
- There are three main ways of using invisible assets to secure debt.
- There are major commercial, financial and fiscal benefits to be gained by using special purpose vehicles.
- A key element is valuing the intellectual property.

balance sheet' of the original company to 'on balance sheet' of the SPV. A rigorously audited intellectual property valuation satisfies lenders and others that the asset has real value and can be lent against.

Tax amortisation is also now available in the UK for newly acquired intangible assets. Prior to April 2002 acquired intangible assets were non-deductible for corporation tax and simply formed part of the capital gains base cost. Now they can be offset for tax on the same basis as the accounting treatment. However, brand companies are more usually established in low-tax locations such as Singapore, Dubai and Switzerland.

Singapore, for example, is a highly attractive location for brand companies because it offers a combination of accelerated tax amortisation, reduced taxation rates on inbound royalty payments, practical assistance with relocation, an attractive location for expatriates and high-quality local staff.

But whether the brand company is based in Zug or Singapore, the attractions are similar. Many companies are separating their brand intellectual property and more rigorously managing them from such locations. Shell and Nestlé, to name but two, now own their brands via brand-owning companies in Switzerland.

Such brand-owning SPVs create a focus for lenders. But to set up a brand company it is necessary first to value the inbound brand intellectual property.

There are three conventional approaches to valuation: cost, market and income. Cost-based valuations consider the costs of creation or recreation, but are not generally used for valuing unique intangible assets such as brands. In the case of market-based valuations it is uncommon for many transactions or quoted prices to be available to benchmark value – particularly the value of brands. Most valuations are therefore based on the income the brand is likely to generate.

While it is possible to value by splitting the income of an operating business, attributing a proportion to the brand, it is more common for valuations to be based on the royalty streams. This capitalises the expected stream of actual or notional royalties attributable to a particular brand. As there are many benchmarks based on actual licensing practice, this is a much favoured approach. In the case of a brand company which has agreements with internal and external licensees, it also reflects commercial reality.

Any lender providing funds to a brand SPV can see a capital asset on the SPV balance sheet and (if it has access in due diligence) can track it through to underlying agreements, revenue projections and valuation models.

As most valuations of this kind are based on future royalty streams, they depend on reliable forecasts. But it is possible to determine the value of brand IP in such an SPV by reference to market royalty rates, auditable licensee sales projections and transparent cost of capital for discounting purposes.

Brand-owning SPVs improve management of brands, allow better disclosure of intangible assets, make value explicit, and provide tax-effective vehicles to lend to. The downside is the danger that in a distress situation the brand-owning company has no tangible assets to grab hold of. If the licensee's underlying sales wilt, so too does the value of the SPV's intangibles.

However, in the current invisible and intangible world this is a danger with virtually all companies. The great thing about brand companies is that they are simple, transparent and focused.

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