

Non-cash funding solutions are becoming more common: are you asking the right valuation questions?

Non-cash funding solutions

With cash still severely constrained many companies are looking to directly or indirectly fund their pension scheme deficits with non-cash assets, such as real estate, unlisted shares, intellectual property or copyrights.

The potential benefits of non-cash funding solutions can be significant for both the company and trustees alike. By using non-cash assets to fund its pension scheme, a company can meet trustees' requests for better scheme security without diverting additional cash from the business. This is particularly welcome at a time when deficits are volatile and borrowing is costly. Quite often the non-cash funding may lead to a benefit to the pension scheme only if there is a deficit at a later date, giving a measure of protection against overfunding which can also make it attractive to the employer.

If a transaction is to be successful a key question both sides need to agree on is "what is an appropriate value to recognise for the non-cash asset?"

Valuation

From the trustee's perspective the valuation attributed to the asset will form a core element of wider scheme funding negotiations and will directly impact the size of the scheme deficit and the scheme security.

From the company's perspective the valuation will affect both the size of the pension deficit and the profit and loss charge recognised in its financial statements under IAS 19. It will also impact the tax deduction it can expect in recognising the value of the asset transferred as a contribution to the scheme.

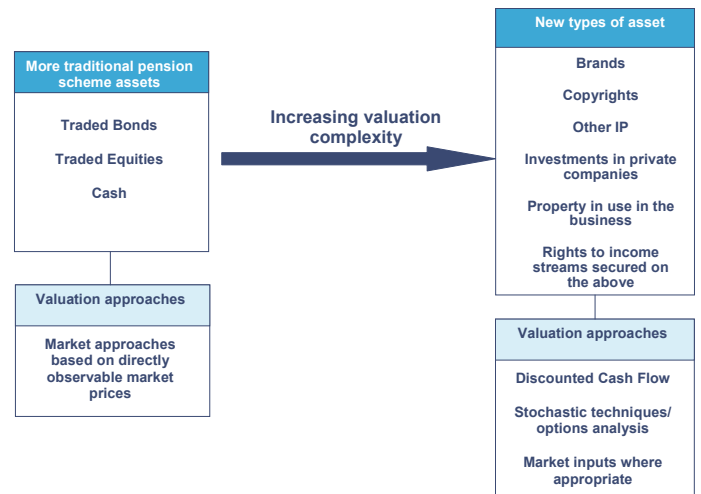
Parties interested in non-cash asset valuation				
Directly affected parties		Other interested parties		
Corporate Sponsor	Pension Scheme	PPF	Pensions Regulator	Others (auditors, scheme actuary)
Value for tax purposes Value for accounting purposes	Value for accounting purposes Value for the PPF levy Discussions with Pensions Regulator and PPF	Value for the PPF levy Assessment of scheme risk	Assessment of viability of funding solution	Value for accounting purposes Value for periodic scheme valuations

In addition to the two main parties to the transaction there are a number of potentially sceptical third parties who, for various reasons, will also be interested in the valuation: Their interest may be driven by regulatory, tax or accounting concerns, but they will all want to understand what the basis of valuation is, how robustly it has been derived, and what support exists for it.



Non-cash asset valuations are complex and unique

The diagram below compares more traditional scheme assets with some typical non-cash assets and the valuation approaches used to value them. In the case of more traditional scheme assets, such as publicly traded stocks or bonds, the valuation question is usually a relatively easy one. By contrast, the uniqueness of many non-cash assets, coupled with the fact that they are not publicly traded, makes valuation questions more complex and the valuation analysis required to support them tends to be bespoke.



What are the valuation issues trustees should consider?

It is the responsibility of the trustees to understand the valuation issues and to be in a position to explain the valuation basis to other interested parties. Trustees need to consider the following:

1. Define the valuation basis up front

The question which the trustees will most often be interested in, and rightly so, is – “what is the asset worth to the pension scheme and how do I value this”? The answer may not be as simple as market or fair value, i.e. what a third party would pay for the asset in an arms length transaction. This is especially true where there are various conditions attached to the asset which a third party might view differently from the pension scheme (from a risk perspective).

Recommendation: The trustees should discuss the basis of any valuation with their advisors at an early stage to make sure it is fit for purpose.

2. Consider the need for an independent valuer

The valuation methods needed to value many non-cash assets are likely to be complex to apply, requiring specialist knowledge to derive a robust and defensible valuation.

Recommendation: If an independent valuation is commissioned then the trustees should agree the basis of valuation and consider how often the valuation should be reviewed.

3. Consider the impact of any specific rights attached to the asset – the devil is in the detail

The value of some non-cash assets may be contingent on uncertain future events or outcomes. This adds another layer of complexity to valuations as stochastic techniques need to be used to assess the probability of such events occurring and their resulting impact on valuation.

Recommendation: Trustees should consider the valuation impact of specific rights attached to the non-cash asset.

4. Consider the impact of business performance on asset valuation

For example where the asset being offered to the trustees is some form of intellectual property, the value of such an asset may be relatively unaffected by the fortunes of the company to whom that asset is linked. Music copyrights would be a good example. By contrast, a corporate trademark might have significant value while the company's business is healthy, but could reduce significantly in value with a decline in business performance and be worth very little in an insolvency.

Recommendation: Trustees should consider how business performance impacts asset value and if they have been granted security over the asset, what comfort that actually gives in the event that the business goes into administration or insolvency (when recoverable value would be most important to the pension scheme).

5. Consider the marketability of non-cash assets

Depending on how any deal has been structured between the company and the pension scheme, the trustees may or may not have the discretion to sell the non-cash asset in the future for cash. Assuming the asset is owned by the pension scheme, how easily can it be turned into cash?

Recommendation: Trustees should take marketability into account when assessing the market value of non-cash assets.

Conclusion

Non-cash assets represent an innovative and efficient way of securing members' benefits, but the valuation issues implicit in these solutions are typically complex, requiring careful consideration by all parties. Identifying valuation issues early in negotiations and addressing those issues in an open and transparent way will ensure common understanding between corporate sponsors and trustees and a robust valuation that stands up to scrutiny by all the interested parties.

For further advice and information please contact:

Assurance – Pensions		Human Resource Services		Pension Advisory	
Andrew Evans	020 7804 3887	Marc Hommel	020 7804 6936	Peter Sparshott	020 7212 4165
Duncan Brown	01727 892 235	Richard Cousins	020 7804 3119	Mark Sambidge	020 7213 1340
Fong Choo Gan	01727 892 201	Chris Massey	020 7804 3637	Adam Sutton	020 780 48124

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