

REALISING VALUE FROM INTANGIBLE ASSETS

Measuring and understanding the value of something that can be neither seen nor touched is a pretty tall order. But that is exactly what needs to be done explains corporate finance expert **Jai Basrur** if organisations are to understand and realise the true value of their intangible assets.

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80%



REALISING VALUE FROM INTANGIBLE ASSETS

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Imperatives

A Chief Executive calls in his leadership team and wonders loudly: Our tangible assets amount to \$50 million but our market capitalisation is \$200 million. I don't understand the reason for this gap in value but I feel it is important to understand the reasons for this gap. As an organisation I feel we need to understand the elements of this difference in value, how to measure and manage it." These conversations are on the increase and are now Board Room realities. The gap between the market capitalisations of businesses and the value of the assets which they report in their financial statements is growing. Some studies estimate that this difference could be as much as 80% of the market capitalisation.

This gap is normally explained as the value of recognised and unrecognised intangible and intellectual assets. They represent a portfolio of perceptions; growth expectations, competencies and capabilities. Studies indicate that the gap between market values and reported values of tangible assets is as much as 80% with an assessed value of \$15 - \$18 trillion.

This is not a straightforward topic. Economic and technology changes have made it more complex, as well. In this short article I have attempted to discuss this topic, relevant principles and considerations in a manner which will enable readers to develop a good practical understanding that they can use.

Intangible assets and competencies now form major transaction considerations as evidenced by the recent acquisition of patent portfolios and research based pharmaceutical companies. Their strategic value is on the increase to businesses of all sizes. They also represent an avenue for raising capital and monetisation.

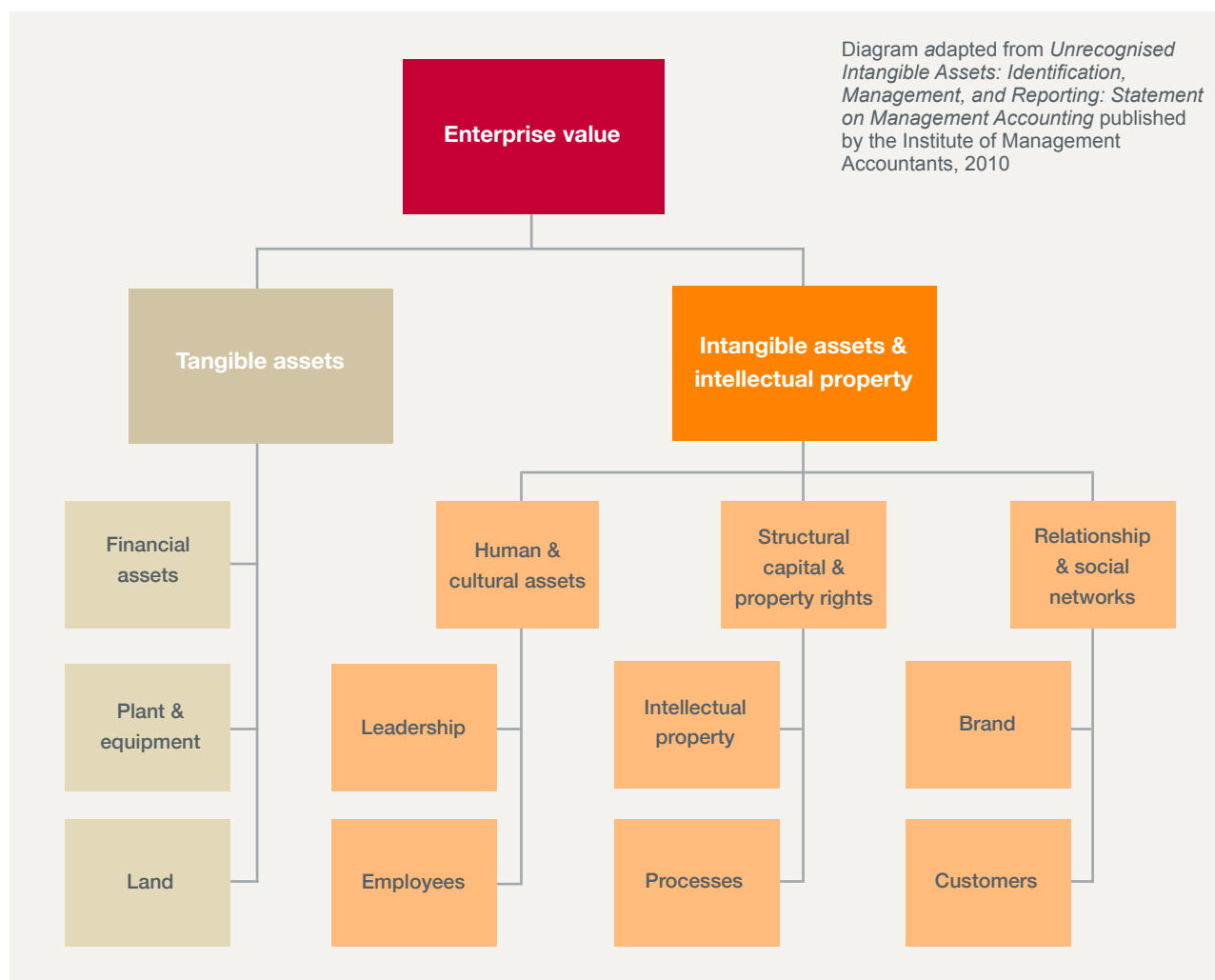
Many take the view that intangible assets are unknown and cannot be measured. This position is no longer acceptable. Markets now expect leadership to manage, clarify and leverage these assets. They are strategically important and the challenge for leadership is to create processes, incentive and a culture for the development of these assets and realise value from harnessing these.

Generating value from these assets requires appropriate strategic choices, leadership, culture and motivation.

I have used the terms intangible assets (IA) to include intellectual capital, property and capabilities (IP) and have also used the terms intangible assets and intellectual capital interchangeably. I have focused on strategic and valuation considerations in this article. Financial reporting and disclosure aspects have been widely canvassed and addressed globally.

Structure

An enterprise's value is the sum total of its tangible and intangible assets (including intellectual property). Tangible and intangible assets can be further analysed into its sub-components. A useful structure for understanding the components of intangible assets is shown below:



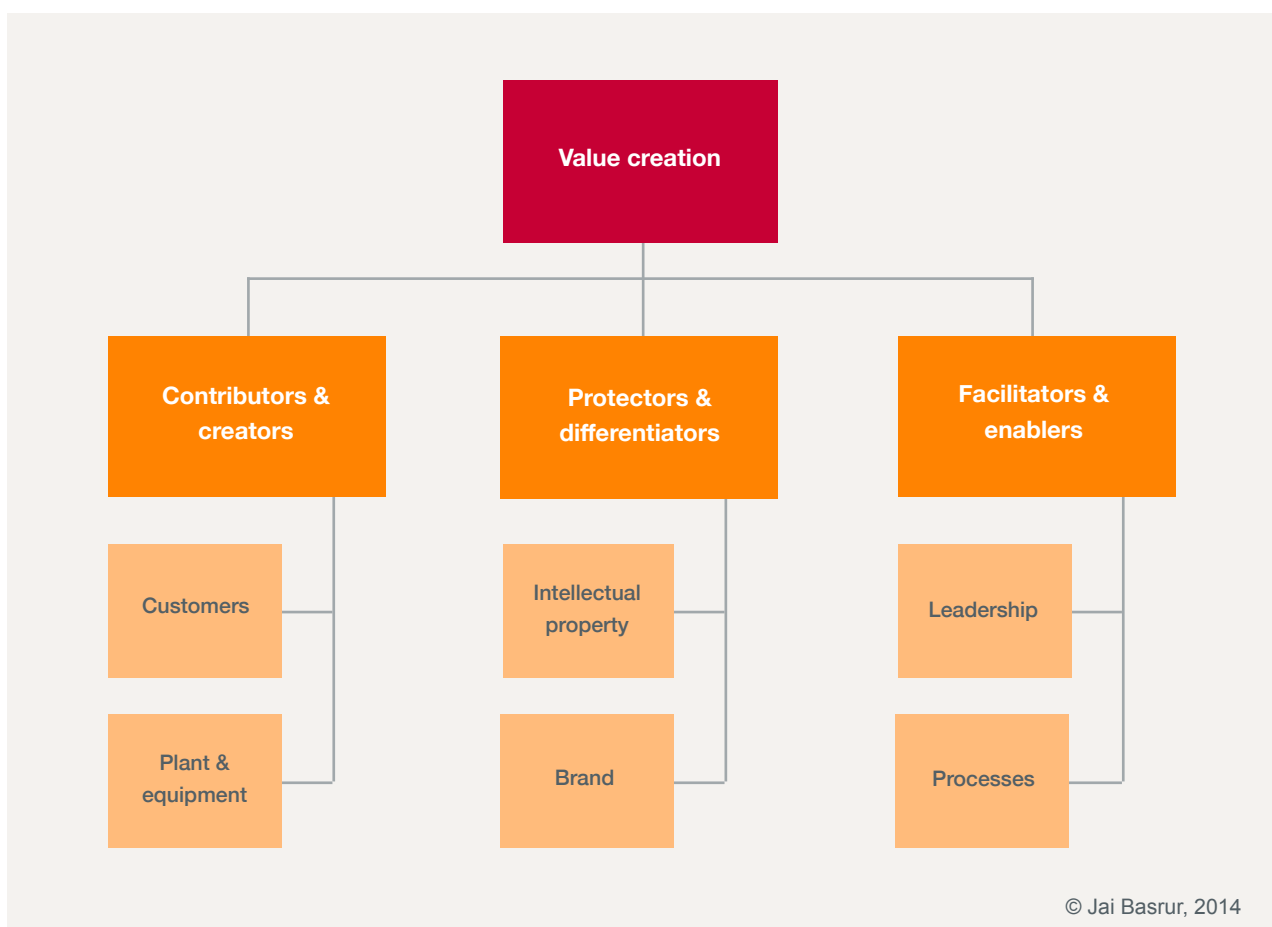
Intangible assets include:

- Unique property rights such as contracts, franchises,
- Relationships (Customer, Assembled Workforce, Distributor)
- Undefined Intangibles (Goodwill)

- Protectable Intellectual Property (Proprietary Technology, Trade Secrets, Patents)
- Enablers (Knowledge, Incentives, Environment)

This structure is useful in understanding how organisational assets are identified, disclosed and reported in financial statements.

From an organisational and strategic perspective, it is also useful to consider intangible assets and capital from the manner in which they contribute and create value. A practical value based categorisation is shown below:



Contributors and creators represent human competencies and relationships which when nurtured by proper leadership and processes enable businesses to create unique positions and competitive advantages. These enable the creation of brands and protectable intellectual property rights. Intangible assets are a broad category of non-physical capabilities, e.g. people's ideas, organisational processes, concessions and skill-sets that create economic value. Intellectual Property (IP) is the legally protected subset of intangible assets, such as patents, copyright, brand names, geographical appellations etc.

At a fundamental level, there is little difference between tangible assets like land, buildings or machines, and intangible ones, like processes, patents or brand names. Without legal protection of ownership rights, both are open to appropriation. Without established benefits i.e. ability to generate economic profits, both have no operating value.

However, managing IA/IP represents an additional challenge. Physical assets are cold and unfeeling. IA/IP assets generally involve people. Managers today need to identify, reward and retain the employees that create most value. This requires an ability to measure the value of IA/IP that the employees create. Few companies currently value IA/IP for internal management purposes. Most consider IA/IP valuation only during financial transactions – for example when negotiating a franchising or licensing arrangement; when convincing financiers to supply funds; or when buying or selling IA/IP.

Valuation

Valuation is the process of determining the worth of any asset – whether physical or intangible. Value represents the incremental value contributed. Valuation is based on applying accepted investment valuation principles. Identifiability and recognition is now well defined in International Accounting Standards.

Goodwill represents the difference between consideration paid or payable and the value of identifiable assets. It represents a portfolio of competencies and enablers. The value of goodwill is normally inferred as it cannot be assessed directly.

Since IA/IP valuation requires us to establish a value today for benefits that will be derived in the future, it is inherently prone to error of judgment, and susceptible to outright manipulation. In addition, the nature of IA/IP makes its valuation especially difficult. In essence it is the incremental value created by the usage of the specific asset being valued.

The first challenge in IA/IP valuation comes from the inability to identify IA/IP and confirm its existence. Managers often confuse mere legal protection for value. Legal protection is necessary, but not sufficient for creating and sustaining economic and business value. Legal protection matters because it provides an ability to protect value from imitators. However, IA/IP creates value only when commercial structures for extracting and maintaining economic benefits are established.

The second challenge in valuation comes from a lack of separability. Sometimes IA/IP may be valuable only in combination with a portfolio of other assets.

We suggest below a structured and systematic framework for approaching the valuation exercise.

Determine the existence of IA/IP

The first challenge is to objectively determine whether the valuation exercise is worth the effort. An IA/IP

asset should generally meet the following criteria before valuation becomes worthwhile and credible:

1. Legally protected: The property should either be legally protected or be amenable to legal protection
2. Identifiable: The benefits from an IA/IP must be distinct, quantifiable and clearly attributable to the IA/IP. These benefits could be any of the following:
 - a. New source of revenue from existing or new products, and existing or new markets
 - b. Protection of existing competitive and revenue position, by creating barrier to competition
 - c. Reduction in cost or capital employed in the business, with a net positive effect on economic profits
3. Material: The benefits should be significant and measurable.
4. Enduring: The benefits must be sustainable over a reasonably long period of time which could be specified.
5. Transferable: It should be possible to isolate and commercially transfer the IA/IP from the existing owner to a new owner either uniquely or as a part of selling the business.

Choose an appropriate valuation technique

Investment and asset valuation methods range from cost based methods to stochastic methods. The choice of method depends largely on the age or maturity of the IA/IP, the level of development and assured benefits, its tradability in a secondary market, and the nature of the industry.

Some practical guidance on valuation methods is tabled below:

Cost based method	Comparable market based method	Economic income methods	Stochastic method
Development cost	Gross profit differential	Net present value of incremental cash flows	Real options
Replacement cost	Premium sales price	Relief from royalty	Gated probability cash flows
Opportunity cost	Market based	Excess profits or national royalty payable	
	Brand strength	Capitalisation of identifiable earnings	

Cost Based methods assume that the value of an asset is the same as the cost of developing it, replacing it, or the cost of the next best use foregone. Unfortunately, value in most cases bears little relation to cost.

Cost based methods are useful in limited cases:

1. When valuing certain monopoly IA/IP, where regulation can constrain pricing to economic cost recovery.
2. When benefits from an intellectual property are unquestionably present but are difficult to quantify.

As an example of the first case, a New Zealand public research organisation was producing and selling its research intellectual property. However, it could not price its research products for economic profit because of regulations. We valued its research intellectual property at cost. Using this valuation, the research organisation could more accurately report its financial performance to its parent ministry.

As an example of the second case, a Singaporean company was undergoing a major change management initiative, which required substantial investment in training. Here, the cost of training was clear, but it was not possible to isolate its direct benefits from the benefits of the entire change management project. We valued the IA/IP associated with the training at cost. Using this valuation, the company could monitor the investment it was making in its people, and benchmark it against the best in class.

Comparable Market Value Based or Guideline Company methods assume that the value of an asset is the same as the price paid for comparables in a market.

Market based methods are normally used:

1. When the IA/IP is tradable and markets are liquid and efficient. E.g. pollution rights and logging or fisheries rights have liquid secondary markets.
2. When IA/IP is not necessarily tradable, but there are enough transactions in the market to allow us to establish comparable transaction benchmarks. For example, brands acquired in take-over transactions.

An example of the first case: we used market value based methods when a network wanted to lease a telecommunications frequency from the licence holder. We valued this frequency using comparable secondary market data. This technique of valuation enabled the company to obtain its required financing and negotiate a better transaction price.

Unfortunately, application of market value based methods is limited because most IA/IP is unique to a business and not developed for trading. It may not have a secondary market of comparables. The lack of comparable transactions or presence of market bubbles and cycles could distort the accuracy of this method and make such comparisons dubious for establishing equivalent value.

Economic income methods use the established technique of discounted cash flow analysis (DCF). This involves forecasting the cash flows from an IA/IP and discounting them back to the present using an appropriate discount rate.

This requires an assessment of the identifiable tangible benefit associated with the asset being valued – revenues, relief from royalties or other cost savings arising from the IA/IP. Forecasts incorporate an assessment of materially relevant customer and competitive factors. Second, the analyst must also make assumption about the life-span and enduring nature of these benefits, and the anticipated rate of erosion or depreciation. Such forecasts must incorporate risks related to the physical, technological, business, or legal sustainability of the benefits. Third, the analyst must make assumptions about the cost of developing and operating the assets. Finally, the analyst must use an appropriate discount rate to establish the present value of the benefits deriving from the assets.

Perhaps the greatest advantage of DCF is that it forces the analyst to make explicit assumptions about the value drivers of the IA/IP, and reality-check them through benchmarking and sensitivity analysis. Management can subsequently monitor the value drivers to ensure that what was planned is achieved. Economic Income based methods are normally useful for valuing relatively mature assets, with established business relationships.

As an example, we used the DCF technique when an Australian ice-cream manufacturer operating under a licensed brand name had created substantial IA/IP of its own in the form of a unique manufacturing process and product. We used the DCF to isolate the value of manufacturing IA from the value of the other components of the brand. Using this valuation, the manufacturer could franchise its manufacturing IA, without a conflict of interest with the brand name owner

Unfortunately, the application of DCF based valuation techniques is limited in the case of immature assets. IA/IP may be so embryonic at the point of valuation that it may be nearly impossible to make the required assumptions. The future may be contingent on the intermediate and interlocking technologies that may not materialise. The path the company takes may deviate from the one planned, as it gains new knowledge and information and reduces technological risk. Difficulty in establishing an appropriate discount rate – which should reflect the intrinsic risk of the asset being valued – may also limit the application of DCF. The Capital Asset Pricing Model (CAPM) – the most commonly used model for estimating discount rates, may fail because the business may not be established, and the asset may be very specific in nature, with no pure-play comparables. In such cases, one has to introduce subjective methods like the risk build-up method or venture capital discount rate method.

Stochastic methods are mainly real options based, and are not necessarily the panacea they are made out to be. However, these techniques do provide a better method of modelling the inherent uncertainty of the IA/IP landscape. This can incorporate probabilistic assessments of the contingent paths that technology could take and the flexibility in making decisions about scale, scope or timing as new information becomes available.

Stochastic methods are useful for assessing IA/IP under development or those subject to very dynamic, volatile and uncertain environments. For example, an Indian biotechnology company undertook

substantial product research. Before commercialisation, the value of this research was only in terms of its potential, and the strategic options it created. This company was keen to enter into a Joint Venture (JV) on a value-sharing basis. We used an option based approach to assess the strategic value of the IP created and used this as the basis for structuring and negotiating commercial relationships with proposed JV partners. This valuation was also useful for designing performance incentives for the scientists developing the IA/IP with the highest commercial value.

Unfortunately, the application of options based techniques for valuation is limited by the perceived complexity of the technique. Companies often have to seek specialist expertise for such valuations.

Making it happen

Businesses increasingly now need to pay attention in understanding, measuring and enhancing the value of these assets. Strong intangible assets and intellectual property positions help to maintain competitive advantages and generate sustainable value. Weakness in this area could leave businesses exposed. Organisations and businesses need to be designed to focus on understanding, measuring and enhancing the value of their intangible assets and intellectual capital. This has to become an integral part of an organisation's fabric and culture. Aligned strategies, organisational arrangements and incentives need to be developed to facilitate the contributors – employees, relationships and customers - to create value. Exciting and uncharted opportunities await businesses which commit to this value journey.

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