The missing trillions: valuing intangible assets

By Paul Adams, CEO EverEdge Global

According to a recent report from the UK Treasury, the world's five most valuable companies are together worth £3.5 trillion, yet their balance sheets report just £172 billion of tangible assets. The other £3.3 trillion of value is missing in action.

Imagine if the directors and management teams of these five companies chose to only actively manage the 5% of assets recorded on their balance sheets. They would be ignoring the key driver of 95% of corporate value – their intangible assets – and critically failing to fulfil their fiduciary duty to manage all their company's assets.

It seems almost inconceivable that directors and management would not actively manage their valuable intangible assets, but we see it happening everyday – albeit to varying degrees, ranging from merely failing to actively recognize these assets to outright denial they are even relevant. A large driver for this is that accounting standards like GAAP or IFRS were essentially designed for an industrial age economy and consequently they almost completely ignores intangible assets, lumping them under the amorphous term "good will" or recording them solely at cost.

When and why should you value your intangible assets?

As the father of modern management theory Peter Drucker famously stated 40-years ago, *"You can't manage what you can't measure"*.

For any company entering into a transaction situation (buy or sell-side); raising capital; paying tax (especially across multi-jurisdictions); conducting research and development; or just wanting to ensure that it is managing all its assets, understanding what intangible assets you – or the company you are targeting – hold and the true value of these assets is essential.

Intangible assets (things like data, content, software code, brands, confidential information, inventions, industrial know-how, and design rights today account for more than 87% of all company value yet, as I mentioned above, they are essentially ignored by modern accounting standards. The result is yawning chasm between company accounts and the reporting based on those accounts, and the reality of what is really driving value, growth and risk within an organization. This behavior also creates or hides major risks and opportunities.

The relative absence of intangible assets from the balance sheet was manageable 40 years ago, when they accounted for only 17% of all company value. But in the last two decades the portion of value attributable to intangible assets has stretched to $80 out of every $100, which means these assets can no longer be ignored. However, many companies still refuse to learn from the mistakes of others who have mismanaged their intangible asset portfolios to their peril.

A stark example of this can be seen in the Nortel bankruptcy filing in 2009, the pre-eminent case study for demonstrating the fact that there is often no correlation between accounting treatment of intangible assets and actual value in market. In this instance, when Nortel filed for bankruptcy its various business units and tangible assets were sold for $3.2 billion. The last assets to be sold were the company's 6000 patents, which in a quirk of accounting rules were recorded on Nortel's balance sheet at cost for $31 million. While the most frothy market estimate of their value was $1 billion, most analyst estimates were far south of this.

These assets were eventually sold for $4.5 billion – 145X the value recorded on the balance sheet and were ultimately worth more than the value of the entire rest of the company. A great result for the company's creditors, but you have to ask whether Nortel would have entered bankruptcy at all if its directors and management team had spent more time actively managing their intangible assets to leverage the portfolios true potential...

With so much of a company's growth and profitability tied to intangible assets, it is as unacceptable for directors to fail to identify and value intangible assets, as it would be for them to fail to identify and value plant and machinery, property or other fixed assets.

Why conventional valuation methods don't work for intangible assets

Understanding how to accurately value intangible assets is an area that remains poorly understood, even among reputable accounting firms.

Conventional accounting standards have not evolved to effectively value intangible assets in the same way as tangible assets. The result is that traditional valuation methods such as cost-based analysis or discounted cash flow (DCF) that work for assets such as real estate or plant and equipment either simply don't work (cost base) or are subject to major challenges which applied to intangible assets.

In the case of cost base approaches there is effectively no correlation between the cost and the value of an intangible asset. In some instances you can spend $10M on R&D and get nothing; in other instances you can spend $100K on R&D and develop intangible assets worth billions.

Income side or DCF based approaches they work well for assets that have stable, predictable revenues and costs. However, the moment the future starts to look different from the past, then the accuracy of Discounted Cash flow Analysis rapidly begins to break down. Unfortunately, in most instances this is precisely the situation where intangible assets are most dominant: new products, new technologies, new markets, new business models etc. In short utilizing a conventional net present value (NPV) approach for new intangible asset rich projects (in isolation of other triangulating factors) is fraught since one thing we can guarantee is that the future will not reflect the past or current situation when it comes to intangible assets.

At this point, conventional valuation theory would suggest looking at comparatives, but this too faces major issues. By definition, intangible assets are more or less unique and differentiated – meaning establishing a benchmark or comparator is extremely challenging. Likewise there is often no liquid market to price seek against.

In short any valuation of intangible assets that draws primarily on conventional (tangible or fixed asset) valuation methodologies should be treated with extreme caution. There is a high probability that the valuation could be out by several orders of magnitude (10x > 1000x).

Take for example, Instagram. At the time of Instagram's sale to Facebook, the company was 20 months old, had no revenue, effectively no assets and 12-employees. A traditional Cost or Cash Flow Basis methods would have said this company was worth $0 yet it was sold to Facebook for $1 billion. Mark Zuckerberg is not stupid, no one pays $1 billion for something without value, the value was there, in Instagram's intangible assets, it's just the conventional approach to these assets, renders them (and their value) invisible.

Fast forward to today, and Bloomberg Intelligence estimates that Instagram would be worth more than $100 billion if it were its own company and not a Facebook division. If true, Instagram's valuation would be 100 times greater than the $1 billion Facebook paid for the photo-sharing service in 2012, which provides an excellent example as to why traditional valuation methods just don't hold up when it comes to intangible assets. In fact, a recent Harvard Business Review article effectively proclaimed the complete irrelevance of conventional company accounts for digital companies. We would argue this goes further to virtually every company today (with the exception of real estate).

How to value intangible assets

While complex, there are methods of valuing intangible assets that can reliably and accurately predict future value. These methodologies work off the general principle that a strong intangible asset position delivers a sustainable competitive advantage that translates into market share or margin premiums that significantly increase the value of the business.

We recently saw this in action when we were asked to provide leading tourism company and the largest provider of recreational vehicles for rent globally, *thl* with an independent valuation to support a joint venture it was entering into. Rather than purely looking at financial performance, the valuation provided an accurate view of the value of *thl's* intangible asset portfolio including the data, content, know-how, process, trade secrets and other information that made up the value of its technology. The value of *thl's* intangible assets offset what would have been a much higher cash contribution had the company not been able to recognize the value these assets would create for the JV over time.

An intangible asset valuation will involve the assessment of a much broader range of factors than are generally included in a traditional valuations. Things like the underlying quality of the intangible assets (for example, the nature of software code; how current and relevant the data is; the breadth of a patent etc), as well contextual factors such as the leverage or benefit those intangible assets will deliver to different potential buyers, investors or partners.

It is also worth noting that with intangible assets that the whole is typically worth more than the sum of its parts, so analysis of the interaction of all these assets grouped together is essential. This is something that is far beyond the skills and expertise of most valuation practices. In an intangible asset valuation, a broader range of factors is typically reviewed and the resulting report will tend to be more discursive, featuring a lot more prose and analysis, with fewer numbers – the aim of the report being to build a solid interlocking framework of multiple, well researched factors that together produce a numerical value that can be relied on.

By way of example: we were recently asked by a start-up to complete a valuation for its new technology and business model around a major infrastructure play. The founders needed to raise $100M. A traditional valuation from a major accounting firm generated a number around $40M, which made the raise non-viable. The CEO approached us for a critique. It rapidly became clear that the initial valuation created using traditional methodologies hadn't captured anywhere near the value of the venture, so we prepared a new comprehensive valuation, which valued the company at $200M.

It would be fair to say the reaction from the accounting firm was incredulity – no venture could be worth this much they argued. However, entrepreneurs don't typically take no for an answer and this founder was no different. He took our valuation to a major investment bank, who enthusiastically adopted the valuation as the center piece of the investment memorandum. The result: the company raised $400M at a $200M pre-money valuation in record time.

And these are not isolated instances. In another example, we worked for a company owner who was selling his financial services firm after 30 years. The investment bank provided a valuation of 4X EBITDA, which the owner did not feel fairly reflected the value of his company so asked us to also prepare a new valuation.

As part of this process, we identified a highly valuable intangible asset (data) that was not listed on the balance sheet and had not been recognized in sale process to date. We prepared a an Intangible Asset Story that highlighted the value of the data, and identified and targeted buyers who we believed would pay significantly more for the data than what the operating company had been valued at. The result: the company was purchased for 32X EBITDA by a strategic buyer who saw the value in the data that had been identified.

What these examples help to highlight is that intangible assets are really the only lever that can move enterprise value beyond cash flow multiples. To fail to actively manage – or account for – intangible assets is to effectively ignore your fiduciary duties as a director or manager. This includes ensuring that intangible assets are factored into any valuation in a way that accurately reflects the company's true worth.

While any valuation exercise needs to be grounded in some form of numerical analysis, it is critical that new qualitative methods are also adopted. Traditional income (DCF) and cost approaches risk becoming lost in the numbers and producing results that bear little resemblance to the reality of value. Instead, an intangible asset valuation should read as a robust, defensible, business-focused report that contextualizes the value of the most valuable and important assets the company owns today.

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