

Attention ABLs...

Are You Undervaluing Your Borrower's Greatest Assets?

To understand the value of a company's assets, whether investing in its equity or extending credit or financing, one has to acknowledge that there is a new world order of business required in assessing the true worth of the business and its underlying assets. That's why it's critical for lenders and other corporate financial executives to work with professionals who can recognize intangible assets, define and research them and know how they work synergistically with other assets.

By Donald E. Anders

The U.S. economy — like those of many other industrialized nations — has changed dramatically in the past 25 years, from one that had been manufacturing-focused to one that is driven by technology and information, service and targeted marketing. But the impact of this evolution hasn't fully connected with all sectors of the investor universe, and they could be missing some powerful business opportunities.

In adapting to the economic transformation, businesses' capital expenditures have increasingly shifted from tangible property like real estate, machinery and equipment to expenditures on the intangible — intellectual property (IP) like technology, customer cultivation and brand development initiatives. Research from the Brookings Institute, in fact, shows how dramatic the shift has been. It estimates that the market capitalization of companies in 1983 was 62% tangible assets to 38% intangible assets. Twenty years later, the ratio was 15% tangible assets to 85% intangible assets.

In a CNN interview after his retirement, Jack Welch, the former CEO and chairman of General Electric — and to some, a revered management paragon — recalled his decision in the mid-1980s “to move up the food chain from the widget business” and change GE from a strictly product-producing company to one focused on service. “Making widgets is a tough game,” he said. “When you don't have an aftermarket for your products, it's a one-time sale. This is not about a precise product or service. It's all about providing customer solutions.”

Missing Half of the Value

Yet, despite this remarkable transformation, the equity and financial instruments markets often overlook or downplay the driving forces behind that structural change. Due to a dichotomy of accounting treatment, IP is not capitalized but rather is expensed, so even though company managers understand the importance of intellectual property to their company's fortunes, they often fail to represent its fair value on the company's books. Thus, the true worth of many U.S. companies' corporate assets is undervalued on the balance sheet. This is evidenced by multiples of book value of equity being two and three times in most industries. In fact, the S&P 500 in 1980 was trading at one-and-one-half times book value, but by 2003 it was trading at three times book value. One of the reasons (beyond irrational exuberance) for this is that the growing value of intangible assets do not appear on the balance sheet unless they were posted after an acquisition.

The definition of “intellectual property,” or IP, can vary. Some confine its usage to anything that can be registered under and protected by such legal instruments as patents and copyrights. This view limits IP to things like trademarks, patents, artistic work, software, trade secrets and industrial design. Others, like AccuVal Associates, apply the term more broadly to include assets such as customer relationships, contracts and orders, licensing and franchise agreements, construction permits and employment agreements.

Undervaluation can negatively influence both equity investment and debt instruments. In an article in the June 2004 Harvard Business Review, accounting professor Baruch Lev says that when investors undervalue these assets, “This burdens firms with an excessively high cost of capital, which in turn leads them to underinvest in intangibles, thereby squandering opportunities for the earnings and growth investors seek.”

How has this happened? In the case of lenders, some remain skeptical of any asset they can't see, touch or put on a truck and take to an auction, should it become necessary to liquidate and close the business. They doubt whether the true value of intangible assets can be measured accurately.

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Defined, Widely Accepted Methods

In fact, the valuation profession uses reliable methods for appraising these vital assets — methods that are widely recognized by national and international accounting and valuation authorities. It requires professional judgment and experience, however, to choose the appropriate methodology and properly apply it. Although the valuation approaches are the same as those used in appraising tangible property, there are differences in formulas, metrics and the way data is analyzed.

How do you value something you can't necessarily see and feel? It begins by training yourself to “see” the hidden benefits in a company's oper-

ations. You also need to recognize that these hidden assets rarely stand alone; they depend on other, complementary tangible and intangible assets for value. Thus, they cannot be isolated like chairs or buildings or inventory, but when bundled together correctly, they become a powerful asset.

Valuation firms regularly identify and aggregate intangible assets for valuation for both public and private companies. We identify the complementary assets, determine the underlying value, and calculate their expected life and income potential. Unlike tangible assets, IP is unique. Whether it's a formula, a process or a cohort of highly trained individuals, no two sets of intangible data are alike.

Valuable Intangible Assets — What to Look For...

In assessing a company's true worth, remember to include all the intangibles that drive its value. Here's a quick list of valuable intellectual property that is often overlooked:

- Patented and unpatented technology, trade secrets
- Spare parts annuity — aftermarket parts business
- Trademarks, trade names, brand names
- Out-licenses with royalty streams
- FCC licenses
- Long-term service contracts
- Favorable lease agreements
- Customer lists and databases
- In-process research and development projects
- Business licenses or permits

Source: AccuVal Associates, Inc. — www.accuval.net

Case Study 1: Expanding the Value of a Brand

In one recent engagement, AccuVal was asked to determine the value of a widely known artificial sweetener. Here, the intangible asset was not just the popular brand name. It was also its: chemical formula, Food and Drug Administration approval and technical expertise to manufacture the raw product.

We knew from experience that transactions involving pharmaceutical, cosmetic or food manufacturing companies, that the brand, the compound and the manufacturing approvals — even if the patents have expired — can have value. If separated, the fixed or intangible assets alone would have a substantially diminished value. Such specialized fixed assets are included in bundled transactions, and there is often a predictable remaining economic life and cash flow of such product lines. The complement of tangible and intangible assets provides a compelling case for investment in a saleable asset.

Case Study 2: Servicing the Installed Base Long After the Sale

Another client seeking financing was looking for the value of certain molds used for the casting of components by an HVAC original equipment manufacturer. If viewed using the criteria for valuing tangible assets, the molds might fetch the value of scrap metal sold at an auction. AccuVal, however, saw the hidden value in these assets — if they were properly bundled and appropriately appraised.

The client had a sizable, measurable and profitable aftermarket parts business using the molds to manufacture the proprietary replacement parts that were needed by their customers. The installed base was created by selling products into installations throughout the world for over 30 years. A competitor would be a likely buyer for this asset, seeking not only the cash flow but also an entry into the installed customer base.

The company's bundle of engineering drawings, manufacturing specifications, installed base and the molds themselves all represented an annuity to the buyer of these assets. Even if no new product were sold and the cash-flow stream declined, it would be predictable, sure money, based on the historical need for proprietary replacement parts for existing customers.

Case Study 3: Broadening the Definition of Intellectual Property

Marketing will continue to drive value in many ways, and the asset value of brand equity will open up more opportunities. Recently, for another client facing financial decision making, AccuVal was asked to determine the value of a popular brand of sunglasses. A narrow definition of that kind of intellectual property would be limited to the legal documents securing the rights to the trademark.

A broader view would include the brand name, which encompasses a group of complementary assets that not only include the legal trademark but also extend to market recognition, customer loyalty, advertising campaigns and supplier relationships. This saleable bundle of assets would be sought by financial buyers and competitors seeking to exploit the cachet of the brand. They could continue to use the brand on subcontractor-manufactured sunglasses or on lesser-known brands of sunglasses, or use it for line extensions even without manufacturing facilities.

Conclusion

In the final analysis, the goal for valuing IP and intangible assets is the same as it is for valuing traditional tangible assets: How much money do these assets represent? To understand the value of a company's assets, whether you are investing in its equity or extending credit or financing, you have to acknowledge that there is a new world order in business that requires new ways of thinking strategically in assessing the true worth of a business and its underlying assets. That's why it is critical for lenders as well as corporate financial executives to work with the right professional who understands how to recognize these intellectual assets, can define and research them, knows how they work synergistically, and applies the best method in assessing their true value. **abfj**

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