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Intangible Assets and Share Value

DO ANALYSTS NEED A NEW MODEL FOR VALUING INTANGIBLES?

By Ray Rath, CFA

The importance of intangible assets to corporate success is well known and widely accepted. Market capitalizations reflect investment in intangibles, which in the US has exceeded investment in tangible assets since the late 1990s. Given their importance, proper valuation of intangibles becomes even

more essential for securities analysts, who face significant challenges in this area. [For more on recent developments related to intangibles, see the report “Assessing Value in the Digital Economy” in this issue.]

In the recent *Financial Analysts Journal* article “Time to Change Your Investment Model,” Feng Gu and Baruch Lev advise analysts to focus careful consideration on “value-creating strategic assets and their deployment.” They also note that EPS is of little use in equity valuation. Gu and Lev essentially sug-

gest that analysts improve how they value intangible assets as well as the business strategies linked with those intangibles. So how can analysts and investors better capture this value?

ACCOUNTING INSIGHTS

The place to start is by examining what kinds of insights analysts can get from the accounting guidance for intangibles. As noted, accounting EPS assessment is of limited value to securities analysts. If anything, the accounting for intangibles increases the variability of reported EPS, which means securities analysts will be busy with adjustments to make EPS more consistent.

Accounting for intangibles is a mixed model on several levels. First, acquired intangibles are capitalized to the balance sheet and typically amortized on a straight-line basis over a finite life. Unlike acquired intangibles, investments in internally generated intangibles are typically expensed as incurred. This difference in accounting treatment leads to EPS inconsistency among otherwise similar companies. To further complicate matters, the amortization of certain acquired intangibles may differ. In global investment bank Houlihan Lokey’s “2016 Purchase Price Allocation Study,” which looked at 455

qualifying acquisitions that closed in 2016, 49% of acquisitions in the study year had a share of the purchase consideration allocated to trademarks. Of these, 23% of the acquired trademarks were held with an indefinite life and the remaining 77% were being amortized over different estimated lives. The differences in lives assigned relate to the acquired trademarks’ perceived durability. These differing assumptions further reduce the consistency of reported EPS.

Accounting standard setters are aware of the challenges that analysts face in valuing intangible assets and have taken steps to improve the relevance of financial reporting by better capturing intangible asset values in financial statements. In 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (FAS) 141, *Business Combinations* (now Accounting Standards Codification 805), requiring the recognition of “individual” acquired intangible assets. FASB also had a project to address internally generated intangible assets. But because audits of valuations of acquired intangibles highlighted the complexities associated with intangible asset valuation, that project did not move forward. In August 2016, the FASB requested comments on whether its future agenda should include a project to assess the accounting for internally generated intangible assets.

GROWTH INVESTMENTS

Investments made by companies can replace existing assets already in place or can be characterized as “growth investments” intended to drive additional revenues and cash flows. Proper valuation of growth investments in intangible assets is also challenging.

In their 2017 *FAJ* article, Gu and Lev use the example of Dell Corporation to highlight the challenges facing analysts. In the years prior to 2013, Dell made significant growth investments to move into the server business (perceived by Dell management as higher growth and higher margin) and away from its declining PC business. The growth investments in developing intangibles related to the server business (such as a skilled workforce, protocols and procedures, and new customer relationships, among others) depressed corporate EBITDA, EPS, and Dell’s stock price. Efforts to educate the market on the combined value of the two businesses failed. The market valued Dell mostly as the old PC business with depressed earnings and a poor outlook, affording less value to the growth business than Dell management believed appropriate. Because of the declining share price and belief that

KEY POINTS

A recent *Financial Analysts Journal* argues that analysts need to change their investment models to capture the value of intangibles.

Analysts and investors need a deeper understanding to gain insights into intangibles because financial reporting standards provide very limited information.

the market was improperly valuing the two pieces of the company, Dell Corporation was aggressively marketed for sale and taken private. Despite extensive efforts to educate possible third-party buyers, the highest bid for Dell of \$24.4 billion came from Michael Dell and a private equity group in 2013.

Assessment of the Dell transaction suggests that the strategy underlying Dell's growth investment (a move to servers) conflicted with a widely held view that the industrywide move to cloud-based services was putting pressure on the server segment. This case reminds us that the value of intangibles investment is closely aligned with both the value of the strategy and the overall market outlook. Determining a strategy's value requires deep industry knowledge as well as an understanding of how the strategy will play out.

HOW TO GAIN INSIGHTS

For securities analysts, several factors limit the helpful insights available from transactions involving intangible assets. Intangibles rarely trade separately from a business, and market data about them is frequently unavailable.

Sales of patent portfolios (technology intangibles) are increasingly reported, but the insights from these transactions are very limited. Company disclosures are often insufficient for analysts to obtain a clear understanding of the transaction. Perhaps most importantly, patent portfolio sales that occur separately from an operating business typically involve an asset that is not "in use." Many portfolios are acquired for defensive purposes or to enhance a strategic buyer's existing patent portfolio. Despite these limitations, Form 10-K disclosures pertaining to intangible asset valuations as a result of corporate acquisitions do provide some insights—most typically on the mix of value from different intangibles and the useful lives ascribed to various intangibles.

Although intangible assets take multiple forms, three types frequently are the most important intangible to consider in assessing a business: (1) customer relationships, (2) technology-related assets, and (3) trade names. For some industries, a fourth type—enabling licenses—may be a company's most important asset. Enabling licenses include government/regulatory, spectrum, franchise agreements, and certificates of need, among others that provide exclusive operating rights to the holder.

INTANGIBLES DURABILITY

In assessing the durability of competitive advantage associated with an intangible asset, analysts must consider the asset's potential life. Trade names can have a potentially indefinite life and are frequently the most "durable" intangible asset (indefinite lives for customer relationships and technologies are extremely rare). An indefinite life leads to no periodic amortization of an acquired intangible's value but rather periodic impairment testing. Houlihan Lokey's 2016 study of purchase price allocations observed that other intangibles with indefinite lives include license agreements, franchise agreements, and certain content or databases. Acquired trade names can be a significant driver of acquisitions and can be recorded on an acquirer's balance sheet with an indefinite life.

In contrast to trade names, technology-related assets usually have shorter lives because of rapid changes in technology. For example, investors and consumers anxiously await each year's release of the latest iPhone and assess the technology changes. Although software technologies may change rapidly, the significant switching costs associated with a move from many Microsoft software offerings provide the company a stable revenue and profit base until technology changes affect these offerings. The shorter lives of these intangibles increase the uncertainty associated with projecting future financial performance for companies that hold such assets.

A third group of important intangible assets is customer-related assets. Most would agree that the recognition and acceptance of the McDonald's name drives the company's success. Customers continue to visit McDonald's because of its reputation for fast, consistent, economic foods. For many business-to-business companies, brands are a minor component. Without technology or other intangibles that create meaningful switching costs, these businesses must make significant investment in obtaining customers. This customer development effort is frequently in direct sales efforts. Expected customer lives for customer relationships acquired in a business combination are typically disclosed for material acquisitions. Because many customers may stay with a provider longer than a single technology or product/service cycle, customer lives are often longer than technology lives. Customer lives reported in acquisitions cover a wide range based on the facts and circumstances of each acquired business.

RELATIVE RISKS OF DIFFERENT INTANGIBLES

Analysts valuing intangible assets should also note the different degrees of risk associated with different investments. If technology-related assets are defined in broad terms, both software development and investment in early-stage development of cancer treatments could be considered investment in such assets. Any similarity between the two is clearly misleading, however, because the two types of assets carry profoundly different risks. Approval rates for drug formulations that have not received Level 1 FDA approval are miniscule (far less than 1%), whereas the risks of software are much different. In addition, as noted earlier with Dell, the acceptance of technology investment in intangibles can vary with differing perceptions of risk.

Although venture capitalists are recognized as investors in the earliest-stage and highest-risk investments, VC investments reportedly have an extremely high failure rate, with 90% or more frequently judged to be failures. Many of these investments are made prior to a company proving the technical, commercial, or financial viability of its efforts. Although returns from successful VC investments are immense, the high failure rate shows the huge challenges involved with early-stage intangibles. The valuation challenges at this stage are numerous. For new technologies requiring regulatory approval, assessing the probability and timing of approval is immensely challenging. Once an intangible asset crosses this hurdle (many don't make it), projections of the commercial market size and share are difficult to make. Finally, developing financial

projections of market share, revenues, and profitability is challenging because of the complexities of assessing a dynamic market subject to the influence of various competitor actions.

Unlike development-stage asset investment, in which capitalization of high-risk intangibles investment is not allowed, some of the investment in intangibles can be capitalized to the balance sheet and subsequently amortized. Subsequent-generation software is an excellent example, because the risk associated with a new version is viewed as very low. There may be little technical risk with completing a new version of existing software. Also, past successful sales likely already established the software's commercial and financial viability. For the investment in updates, accounting rules allow the capitalization of software investment. For many pending updates of existing software, the primary risks may concern whether the new version will be completed on time and on budget.

Another area for analysts to consider is the impact of capital and other resources on the value of intangibles. Some companies use their capital resources as a source of competitive advantage. For instance, Facebook has acquired several companies that represented potentially disruptive competitors. These acquisitions served to protect the value of Facebook's existing customer base, technology, and overall business model. Over the years, Microsoft has also been noted as a company willing to acquire other companies that presented varying degrees of competitive threat to its existing operations. Yahoo also made a significant number of acquisitions over a period of years. Unlike Facebook and Microsoft, which had strong market positions when making defensive acquisitions, Yahoo's market position was weaker than many of its emerging competitors. Its transactions and strategy did not reposition Yahoo to a sufficiently strong market position, and the company was subsequently acquired by Verizon. Competitive use of capital is yet another complex wrinkle for analysts to consider.

Accounting for business combinations provides further evidence of valuation challenges. The release of FAS 141R in 2007 (effective for transactions after 15 December 2008) revised accounting rules. After it went into effect, contingent consideration (CC) elements in transaction structures had to be valued at their fair value and included in the determination of the purchase price paid. Approximately 19% of the business acquisitions included in Houlihan Lokey's 2016 study had CC included in the purchase price. Among the cases included in the study, the median contingent consideration paid was 14% of the total purchase consideration. The inclusion of contingent consideration presumably reflects the inability of a buyer and seller to agree on the value of uncertain intangibles, hence the inclusion of contingent payments in the transaction structure.

Analysts interested in a greater understanding of the recognition and valuation of intangible assets for financial reporting purposes can learn much from several guides released to enhance valuation practice for intangibles. Interested readers are advised that the publications provide extensive discussions and detailed calculations appropriate for financial reporting. The theories and calculations covered may require

significant modifications to meet a securities analyst's objectives. (As an important example, future customers do not meet asset recognition criteria for financial reporting. Although a buyer is likely to include some payment for future customers, this value will wind up as a part of the goodwill recorded for the transaction.)

These resources include the following:

- The Appraisal Foundation, Best Practices for Valuations in Financial Reporting: Intangible Asset Working Group, "The Identification of Contributory Assets and the Calculation of Economic Rents," issued 31 May 2010.
- AICPA Practice Aid, "Assets Acquired to Be Used in Research and Development Activities," issued 2013.
- The Appraisal Foundation, "The Valuation of Customer-Related Assets," final document issued June 2016.
- The Appraisal Foundation, "The Measurement and Application of Market Participant Acquisition Premiums," final document issued 6 September 2017.
- The Appraisal Foundation, "First Exposure Draft: Valuation of Contingent Consideration," 28 February 2017.

Another resource pertaining to intangibles valuation as well as business and securities valuation is the Mandatory Performance Framework (MPF) developed by Corporate and Intangibles Valuation Organization. The MPF sets forth minimum required procedures for certain financial reporting fair value estimates and includes detailed requirements related to intangible assets.

Note that various bodies, including the SEC, have noted that the overall quality of fair value measurements could stand improvement. These observations led to the release of a Certified in Entity and Intangible Valuations (CEIV) credential for financial reporting. Also, guidance on minimum valuation procedures to perform and document was set forth in an MPF document and related Application of Mandatory Performance Framework published by the Corporate and Intangibles Valuation Organization in 2017.

CONCLUSION

Intangibles are and will continue to be an important driver of corporate value. Identification and valuation of intangibles requires informed judgment and the full range of business valuation skills. Early-stage, high-risk intangibles are very difficult to value. Although venture capitalists are some of the brightest minds in business strategy, finance, and their industries of focus, studies suggest that the vast majority of VC investments (as high as 90% in some studies) are unsuccessful. In addition, our assessment of Dell suggests that the strength (or perceived lack thereof) of corporate strategy will drive the valuations. Analysts will need to develop better tools to recognize and capture valuation creation from intangibles and the related corporate strategies. Given the dynamic nature of intangibles and markets, models will require frequent updates and significant insights and informed judgment.

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