Doing deals: Intangible assets, a key value driver?

"I can make a whole lot more money skilfully managing intangible assets than managing tangible assets."
— Warren Buffett

BY LEONARD WOO

In today's technology-driven climate, we are seeing Internet or social network-related deals with interesting valuations, often driven by the perceived value of intangible assets.

Just last month, Yahoo paid US$1.1 billion (RM3.42 billion) for Tumblr, a relatively new social network that recorded a US$25 million loss on the back of a modest revenue of US$13 million last year. Tumblr is an asset-light business model, so I doubt Yahoo was paying for tangible assets in that deal.

A few months earlier, Facebook submitted a US$1 billion bid for Waze, the provider of the free social GPS application, a business that has yet to make a dime of profit.

In the more traditional brick-and-mortar sector, and closer to home, when Maybank acquired Kim Eng, it paid a price-to-book (P/B) multiple of two times. And when Hong Leong Bank acquired EON Bank, about 50% of the purchase price was attributed to EON Bank's intangible assets.

When buyers are willing to pay a premium over the book value of tangible assets on the balance sheet, they obviously see the value of "unseen assets with no physical substance", or what accountants would call intangible assets.

And if investors or buyers are willing to pay a significant amount of money for intangible assets, it makes business sense to correctly identify these intangible assets, placing the right value on them (ideally pre-deal), and recognising the potential impact on future earnings if such intangible assets are impaired post-deal.

Increasingly, we are seeing deals valuation driven by the target's established market reputation, brand equity, speed to market, customer base, intellectual property (IP) rights, skilled workforce or exclusive licensing rights. These intangible assets are often not captured on the target's balance sheet.

In a knowledge-based economy, just the sheer size of physical or financial assets on the balance sheet is no longer adequate in determining the future success of a business. Instead, the assets with no physical substance are often the competitive advantage that drives up the value of the deal.

As our market grows more sophisticated, investors are looking beyond the traditional returns expected from tangible assets. They now look at the potential return or value add from intangible assets at all stages (start-up, growing or matured) throughout the business life-cycle.

Recognising the importance of intangible assets, the Malaysian government is developing an IP market platform, with the hope that IP will soon be recognised as an asset class by banks, and will qualify as collateral for financing. A sum of RM200 million was allocated under Budget 2013 for financing loans where IPs are used as collateral.

Valuation of intangible assets

The business community has been embracing intangible assets for a long time, as reflected in the premiums paid over tangible assets on balance sheets in M&A deals.

So how do we begin to value these intangible assets?

The International Accounting Standards Board has issued accounting standards to ensure companies reflect these intangible assets accurately in their financial statements. This helps to more accurately reflect a company's position in the event of a deal. The standards differentiate between:

- identifiable intangible assets; and
- unidentifiable intangible assets or goodwill, calculated as the residual value of purchase consideration after deducting the net tangible assets and identifiable intangible assets.

Intangible assets are typically classified into a few broad categories like marketing, customers, technology, contracts, patents and so on. Intangible assets may vary across industries. For example, in the telecommunications sector, it could include spectrum rights and statutory licences to operate.

Generally, unidentified intangible assets, such as synergies, skilled workforce, presence in geographical markets and favourable client or supplier relationships, are captured as goodwill.

Identification of intangible assets needs to be done precisely or it's a pointless exercise. Take customer relationships — the good experiences and relationships between you and your customers could be the key drivers for maintaining customer loyalty and would warrant a higher valuation. However, a customer database containing only customer details does not have the same earnings generating capacity, and would be valued lower.

Can we really value assets with no physical substance accurately?

Getting an absolutely accurate valuation for tangible assets poses a challenge for many skilled valuers, what more intangible assets without physical substance?

But there are some well-recognised approaches commonly adopted by valuation practitioners. The three common approaches are:

1. Market approach — based on multiples or prices from market transactions involving comparable intangible assets. However, this approach is rarely used because there are not many identical transactions in the market.
2. Income approach — based on the present value of earnings attributable to the intangible asset or costs avoided as a result of owning the intangible asset: "an asset is worth what it can earn". Although this is a commonly used approach, the key is being able to demonstrate how the intangible asset can generate tangible earnings. For example, how do customer relationships contribute to earnings?
3. Cost approach — based on reproduction/replacement cost required to replace the service capacity of the intangible asset.

Significant judgement is often required in the valuation of intangible assets. Some of the common challenges are:

- Identifying or segregating the relevant cash flows arising solely from the intangible assets, separating these from cash generated from the business as a whole;
- Determining the useful lives of an intangible asset. Does it have a finite or indefinite life? Quantitative and qualitative factors like historical data, product life cycles, technological and commercial obsolescence need to be taken into account; and
- Determining the appropriate valuation parameters, the ability to obtain similar comparable transactions in the market or the appropriate discount rates.

While we see intangible assets increasingly being a key driver of deals value, the rigour of identifying and valuing intangible assets is often lacking pre-deal.

Are you getting what you paid for?

Investors live by one very practical mantra — do not overpay.

If the thrill of chasing a deal overtakes the valuation discipline, overpayment for any intangible asset will come back and hit your future reported earnings. Accounting standards require intangible assets not supportable by future cash flows to be impaired and this will have an adverse impact on future reported earnings. In 2011, AT&T took a US$2.75 billion goodwill impairment hit on its reported earnings, and a trademark impairment of US$165 million.

So while it may be true that, "a whole lot more money can be made by skilfully managing intangible assets than managing tangible assets", identifying the relevant intangible assets and valuing them appropriately to avoid over-paying is critical in getting the right deals done at the right price. E

Leonard Woo is an executive director in PwC's Valuations & Strategic Value team. This is the second of six fortnightly articles by PwC Malaysia's Advisory practice. This series looks at how businesses can manage change amid uncertainties by strengthening fundamentals and planning ahead. The next article discusses how the HR function can become a strategic partner to the business.