Intangible assets: How they impact a company's value

TRUST IN Resilience

BY ANDREW CHAN

Think of a company you like. Why do you like it? Is it because it makes its products ethically and responsibly? Or is it the fact that you know it treats employees well?

If you find yourself taking those factors into consideration when deciding where to shop for clothes, or which stocks you would buy with your hard-earned money, you can be sure your customers and investors are doing the same.

Today, the full picture of a company's value cannot be captured on a balance sheet because "value" is not just dollars and cents anymore. Amid megatrends like demographic and social change, technological breakthroughs, and climate change and resource scarcity, one profound change that is taking place is the shift in market value: The growing importance of intangible assets over tangible assets like financial capital and physical assets.

But what exactly are intangibles? Several variables that fall under this category are brand value, governance, reputation, customer and employee engagement, social licence to operate and environmental performance.

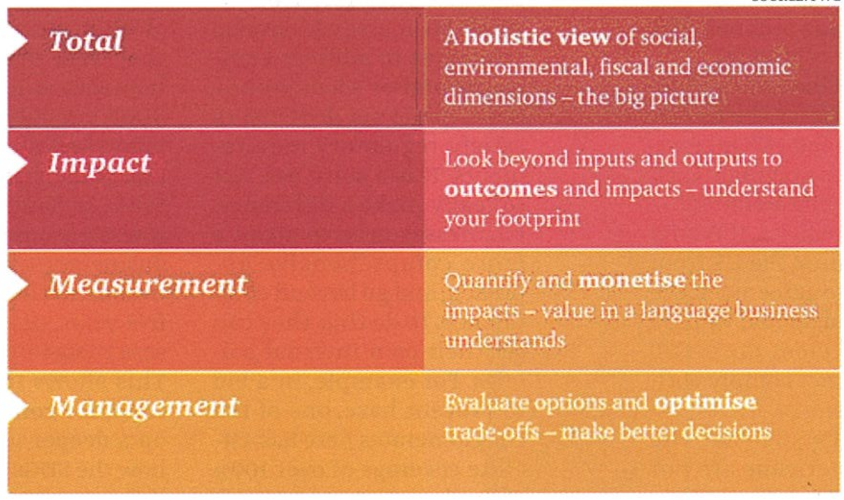
A study by Ocean Tomo — an intellectual property merchant bank that provides financial products and services — found that 42 years ago, only 17% of the S&P 500's value was derived from their intangible assets. But today, that ratio has reversed. In 2015, intangible assets contributed 84% to the S&P 500's value. The numbers tell us that the concept of "value" has certainly evolved. But how?

Four ways intangible assets affect company value

1. **Brand value and governance**
If you want to understand the power of brand value, just ask yourself: Why do you use Google and not any other search engines? (The others exist, you know.) Essentially, it is because you trust Google. There are many ways to create brand value. A great marketing campaign can help, of course. But a top contributor is, without a doubt, quality of governance. Those who think otherwise would do well to remember businesses that have exercised poor governance in the past. Think horsemeat and defective airbag scandals. In the case of the latter, the air bag manufacturer experienced close to a 10% plunge in share price after four Japanese car makers announced they were issuing a worldwide recall of vehicles supplied with the manufacturer's faulty airbags. This case revealed some inconvenient truths about poor governance — it leads to damage of reputation, and perhaps more severely, an erosion of trust among stakeholders, both of which ultimately contribute to financial loss.

2. **Employee engagement**
There is a positive correlation between good employee engagement and stronger company performance. We intuitively know this, but data has proven it. A study over a 27-year period found that the 100 best companies to work for in the US outperformed their competitors by 2.3% to 3.8% per annum. That should not be surprising. Employees today are seeking more than just salary and benefits in a job. They want to be engaged in work that gives them a sense of purpose. Which is why companies that strive to create value in the lives of their employees by providing skills training, for example, will generally find employee productivity improving. To illustrate my point, the professor, who sponsored me as a visiting scientist at the MIT Sloan School of Management, did a study awhile back, comparing two factories that manufacture shoes for a well-known sports brand. The study found that the factory that placed greater emphasis on employee engagement and working conditions initially suffered a loss. But this was only temporary; the factory quickly broke even, and then outperformed its sister factory in terms of profit.

SOURCE: PWC



(PwC's Total Impact Measurement and Management [TIMM], which puts a positive or negative value on impacts across society, tax, economics, and the environment.)

3. **Social licence to operate**
Today, there is greater expectation for businesses to exercise more responsibility towards their communities and the environment. Companies that have been embroiled in oil spill and child labour controversies have shown us what will happen when businesses lose their social licence to operate. At best, they take months to recover and rebuild trust among their stakeholders. At worst — years. Neglecting this responsibility can also hurt a company's longevity. Just look at the average age of S&P 500 companies today. It used to be around 60 years. But today, it falls below 20. Malaysia, too, has its fair share of companies that are no longer around, including a petroleum company and a local bank. While there is no denying that it usually takes a combination of factors for a company to fail to survive, one significant cause is having a mindset that is focused on short-term profitability, as this rarely helps companies keep their social licence to operate in the longer term.

4. **Environmental performance**
With business schools increasingly teaching sustainability in their curriculum, there has been greater environmental awareness, especially among the Gen Y. Several companies in Southeast Asia and the US have told me that nowadays, Gen Y consumers are more willing to spend on items they know have been produced sustainably. The success of Earth Heir, a local eco-friendly brand that specialises in making fashion accessories and clothing using sustainable practices, is a prime example of how much consumers are beginning to care about a business' impact on society and the environment.

Besides winning the favour of today's environmentally conscious consumers, businesses that improve their environmental performance will also see that this often translates into cost savings. A small medium enterprise in Malaysia that produces plastic wrappings has shown us exactly that. The company reduced the thickness of its plastic from 0.15 to 0.12 micron for similar product performance. Not only did this lower the environmental impact, it also reduced the company's production and shipping costs per unit as well.

So, it is clear that intangible assets play a pivotal role in boosting a company's overall value. Failure to pay them the required attention puts companies at risk of losing favour not only with their customers and employees, but also with their investors. What can businesses do to ensure their intangibles continue to positively impact their company's value?

Five ways to protect your intangible assets

1. **Have a value-focused purpose**
There is a vintage packaging for a soap brand you will still find on the shelves today that I really like. The reason is that being in the limited space available, it had chosen to communicate the company's purpose. Today, in an environment where businesses are constantly under scrutiny, two fundamental questions companies must ask themselves are: Are we in it to profit maximise? Or value optimise? (To what extent that value is economic, social or environmental, is up to you to define.)
I am of the opinion that every company should have a purpose or a "mission statement" that centres on optimising value. This is a top priority, as doing so will guide companies in making better business decisions. Just as important, it will also inspire and remind employees of why they do what they do, and thus improving employee engagement. On the contrary, we have seen that often when a company is only concerned with keeping its bottom line well fed, the value of its intangibles takes a hit — lowering the company's overall value.

2. **Use frameworks to achieve your goals**
A group head of strategy once told me that at his company, environmental and social impact discussions depended on the gut feel of those sitting around the management table. Sometimes, good decisions are made. At other times, wrong decisions are made that end up costing the company a lot of money. A robust framework (like PwC's TIMM) removes the reliance on intuition by quantifying "qualitative" elements with dollar figures. This allows companies to weigh up their options: is it worth making less profit, but have greater social impact?
(PwC's Total Impact Measurement and Management [TIMM] puts a positive or negative value on impacts across society, tax, economics, and the environment. Source: PwC.)
Kering Group, the French owner of various top luxury fashion brands, was seeking to assess its environmental impact throughout its supply chain. Our colleagues in PwC UK helped the group adopt the TIMM framework to create the world's first Environmental Profit and Loss (EP&L) account with athletics goods maker PUMA. With this EP&L, they discovered that 75% of their environmental impact was from the transformation of raw materials into products. By identifying the area they needed to focus on, this offered them a new perspective on their business, helping them rethink some of their business decisions like the types of raw materials they choose to use, or where they decide to source their materials from. This ensured they had better control of their environmental impact by being in a better position to manage and protect the resources they ultimately depend on.
BASF, one of the world's largest producers of chemicals, plastics, performance products and crop protection products, has also used our TIMM framework to develop its own methodology to quantify its economic, ecological and social impacts along the value chain. Called the "value-to-society" approach, it was created out of the company's desire to increase its contributions to society, and lower the negative effects arising out of its business activities. With this model, monetary value is calculated for both financial impact categories (profits, taxes, wages and benefits) and the non-financial. The non-financial aspect is where TIMM comes in. Human capital, health and safety, and environmental impacts are what many would believe are "intangible concepts" (for example, how do you quantify the impact of water usage on your raw materials?). With the application of valuation coefficients provided by TIMM, BASF is able to present the impacts of those three factors in monetary terms, aiding in more balanced discussions and informed decision-making.

3. **Educate stakeholders through disclosure practices**
Businesses can use disclosure practices like Integrated Reporting (IR) to help change the mindsets of stakeholders that do not appreciate the value of longer-term decision-making. Because IR focuses on the variables that create value to a company (including intangibles like governance, employee engagement and operational excellence), the data enables businesses to point out to these stakeholders the specific areas that are generating value.

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Avoid making short-term financial decisions

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4. **Implement internal policies that make a difference**
While businesses do develop strategies to address environmental or social issues, they should not do it just to satisfy regulatory requirements. It is a start, yes. But to really make a difference, businesses need to adopt a more comprehensive approach, and go beyond compliance. To do this, they can set their own internal policies. For example, in a bid to prevent haze, one of the conglomerates here has satellite coverage of over 100% of its plantations to monitor and respond to hotspots. This initiative helps it maintain its social licence to operate.
5. **Improve your organisation's understanding of sustainability**
A good piece of news I am hearing from friends is that their children are coming home from school with an awareness of the UN's Sustainable Development Goals (SDGs). This is certainly encouraging, as it shapes how our next generation of businessmen and women view the role of business in supporting the sustainability agenda.

Education is just as important at the corporate level. In PwC's 2015 SDG survey, we found that globally, 71% of businesses said they were already planning on how they will engage with the SDGs, but only 13% of them had identified the tools needed to assess their impact against the SDGs. In Southeast Asia, while it was encouraging that 97% of businesses said they have plans to address the goals in the next five years, only 45% plan to assess their impact on the SDGs. This shows that there is still room for companies to develop a deeper understanding of how the SDGs impact business, if they are to embed them into strategies.

Indeed, the idea that sustainability is all about going green and looking good must be replaced with the understanding that sustainability affects business resilience, impacting areas from operations and human resources to governance and customer strategy. That is why it must not be treated simply as a public relations effort by the organisation's corporate affairs team, nor as pure reporting compliance. Instead, those at the top should encourage all employees to change the way they view sustainability. This can be done by defining sustainability in a manner that is consistent with the company's purpose.

Conclusion

The perception of value is changing, with intangibles playing a critical role in a company's success. Though increasing the worth of your intangibles is a long-term journey, it is one that will boost your company's value if done right. The key thing to remember is to avoid making short-term financial decisions and losing sight of what your company stands for.

As Sultan Nazrin Muizzuddin Shah, the Sultan of Perak, said in his speech at the Khazanah Megatrends Forum 2014, "Such short-termism runs contrary to the spirit of sustainability, which aims to maximise not present gains but rather value generated over the long run." Indeed, his message on the need to shift our worldview from a paradigm of maximisation to one of optimisation should be a point to remember for a greater chance at long-term success. E

Andrew Chan is consulting leader (PwC Malaysia) and sustainability and climate change leader at PwC's South East Asian Consulting services