

Intangible Asset Valuation, Resource Management and Strategic Planning **– leveraging the value of intangible resources**

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Competitive advantage is increasingly due to the development, integration and reconfiguration of intangible resources. Yet few companies have a clear appreciation of the current and required 'stock' of specific intangibles. This leads to sub-optimal corporate strategy.

Valuers can make a meaningful contribution to the evolving discipline of intangible resource management by ensuring that it is tightly linked to value creation. This is critical if it is to gain general acceptance. There is also something for valuers to gain. Solid approaches have been developed to value intangible assets. Yet their role in the value chain is complex, and it is premature to believe that the best possible methodologies and definitions are always applied. Frameworks and insights gained from other players in the intangible arena can ensure that our valuations are aligned with commercial reality. Insights can be gained from:

- *Corporate strategists* who are re-evaluating resource-based management theory to incorporate intangible capital.
- *Market researchers* who continually evaluate the functional and emotional product attributes that influence customer choice. Quantitative analysis can also reveal the linkages between the drivers of demand and specific resources.
- *Transfer pricing economists* who are increasing their understanding of the excess returns that can be attributed to specific intangible assets.
- *Intellectual property managers* who are exploring a variety of ways to commercialise intellectual property (IP). This requires an understanding of the value that third parties place on IP, both separately and when bundled.

A pooling of knowledge provides the clearest understanding of the current and potential value of intangible resources. This article provides an integrated overview of how intangible resources drive cash flows, and how this knowledge can be used to enhance enterprise value by:

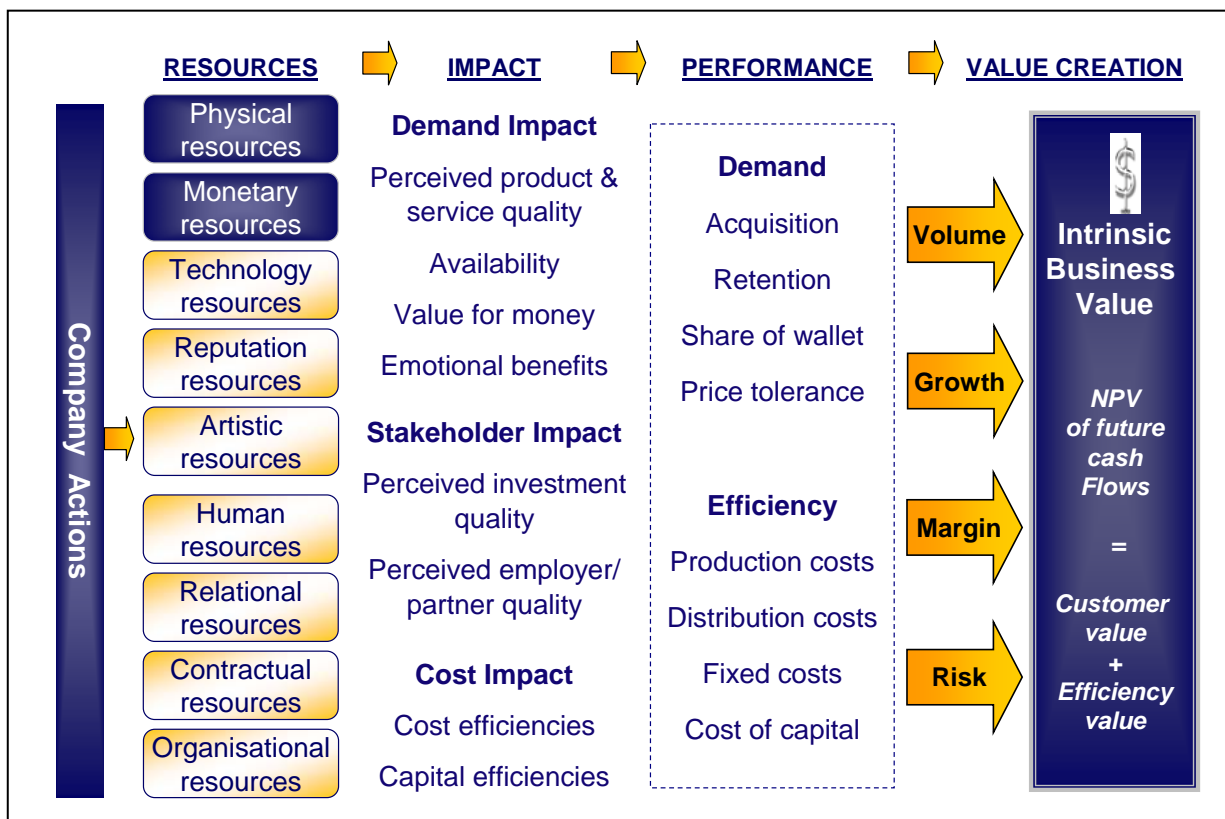
- (i) Tightening the operational management of intangibles. This covers strategy selection, investment allocation, and performance evaluation.
- (ii) Adopting a more aggressive approach to the financial management of intangibles. This involves licensing, structured financing, tax planning and transactions.

The Role of Intangible Resources in the Value Chain

The use of the term 'resource' to describe items such as brands, patents and relationships helps managers grasp that they have to be actively managed and protected. The adage of 'sweating the assets' is particularly relevant to intangibles, which frequently slip beneath management's radar screens.

Diagram 1 is best read from right to left. The concept that the value of a business is the net present value of future cash flows is not contentious. Nor is the premise that corporate strategy should be directly linked to driving future cash flows. The trick is to link demand and efficiency drivers back to the contributing resources, tangible and intangible, and ultimately to investment decisions. This is best achieved by identifying the sequential stages in the value chain.

Diagram 1: Driving value through effective resource utilisation



The drivers of cash flows (volume, growth, margin and risk) are influenced by demand and efficiency performance. Consumer perceptions are crucial to demand performance. These are largely influenced by the relative quality and quantity of resources deployed by competing firms. For instance, a perceived quality differential might be due to better manufacturing resources, or it might be due to a stronger brand. Quantitative market research can provide important insights into the perceptions influencing customer acquisition, retention, frequency of purchase and willingness to pay a premium.

Quantitative analysis can also inform the linkages between resources and consumer perceptions.

The diagram is generic and has been simplified into a linear framework. The importance of different resources will differ according to the sector in which a company operates, and its core competencies and means of differentiation. The second complication is that business models are not linear. Linkages between resources need to be understood, at least in a broad context. Baruch Lev, Professor at New York University's Stern School of Business, has stated that '*when such interactions are intense, the valuation of intangibles on a standalone basis becomes impossible*'.¹

Value creation maps can be used to identify the relative importance of resources and the linkages between them. These maps illustrate how the resources of an organisation are deployed to create a differentiated market position and generate cash flows. The sophistication of value maps varies depending on their application and the availability of information. Systems dynamic modelling techniques provide a useful basis to capture and illustrate non-linear relationships. The direction and extent of the resource interrelationships, and their role as value drivers, can be estimated through a combination of market research, statistical analysis of historic data, and Delphi techniques.

Some consideration of definitions is required. Accountants speak of intangible assets, lawyers of intellectual property and strategists of intellectual capital. In this paper, the term *intangible asset* has been used where items meet the definition of AASB 3. Intellectual property is a subset of intangible assets. The term *intangible resources* will be used to cover a broader set of intangibles, including items that contribute to business performance, but do not meet the accounting definition. *Intellectual capital* is generally used in a similar context.

The following categories of intangible resources are used in Diagram 1:

- Technology resources (such as patents and software)
- Contractual resources (e.g. distribution agreements, licenses)
- Reputation resources (trademarks)
- Artistic resources (copyright, design rights, recipes)
- Human resources (competencies, staff engagement)
- Relational resources (suppliers, intermediaries, joint venture partners)
- Organisational resources (processes, culture)

¹ '*Intangibles: Management, Measurement, and Reporting*', Baruch Lev. The Brookings Institute.

These groupings are based on the role that the resources play in the value-chain, rather than on levels of ownership or control. The main differences between with accounting definitions are:

- (i) The identification of items such as relational resources which would be included in residual goodwill in a purchase price allocation.
- (ii) The omission of customer based intangibles. As all cash inflows are derived from customers, enterprise value is ultimately a combination of customer value and efficiency value. Customers are the result of the effective deployment of a company's resources. Although it is pragmatic to allocate value to customer contracts for purchase price allocations, this is not helpful from a commercially perspective. Managers need to understand what is underpinning customer cash flows, and realise that the erosion of any of the building blocks will impair future earnings.

Improved cash flows through better operational management of intangibles

Knowledge of the building blocks of enterprise value, is essential for both strategy and risk management. Outsourcing is a good example of how a resource exchange can require a shift in management skills². A company that outsources manufacturing is exchanging a physical resource for a relational resource. If management's strategy, skills and procedures do not adapt accordingly, it is unlikely that the economic return extracted from the relationship will be maximised.

Executives are becoming accustomed to post purchase allocations, and their commercial curiosity should be demanding a value breakdown of all business units. An indicative break down of enterprise value by key resource categories is a good starting point. A value mapping exercises then provides a better understand of the value drivers in each material market segment. This enables better strategy selection, resource allocation, tactics, and performance tracking.

At the outset executives should challenge whether the existing strategy is aligned with market forces and the company's resource holdings. It is the quality and quantity of resources that create core competencies and differentiation. Each resource can be regarded as a stock which has both inflows and outflows, so investment decisions must take account of the importance of each resource, and the gap between the current and required resource level.

As marketing is one of the biggest expenses in many P&Ls, it will be used as an example of value-based resource management. A primary focus of the marketing budget is the

² *'Managing Intellectual Capital in Practice'*, Goran Roos, Stephen Pike, Lisa Fernsröm. Butterworth_Heinemann.

development and protection of reputation resources. This might be in the form of a single corporate brand, or a portfolio of brands. Marketing directors are inclined to demand higher budgets, citing issues such as media fragmentation and declining share of voice. CFOs, on the other hand, tend to regard marketing budgets as the first port of call when times are tough. An economic framework brings some objectivity to the discussion.

Within each market segment it is necessary to gauge the relative importance of the brand as a revenue driver. For instance, how important is it relative to relationships with key distributors, price, or product features? This can be determined by market research which can also quantify the current strength of the brand. Knowledge of the importance of the brand resource and current holdings of this resource are fundamental to the investment decision.

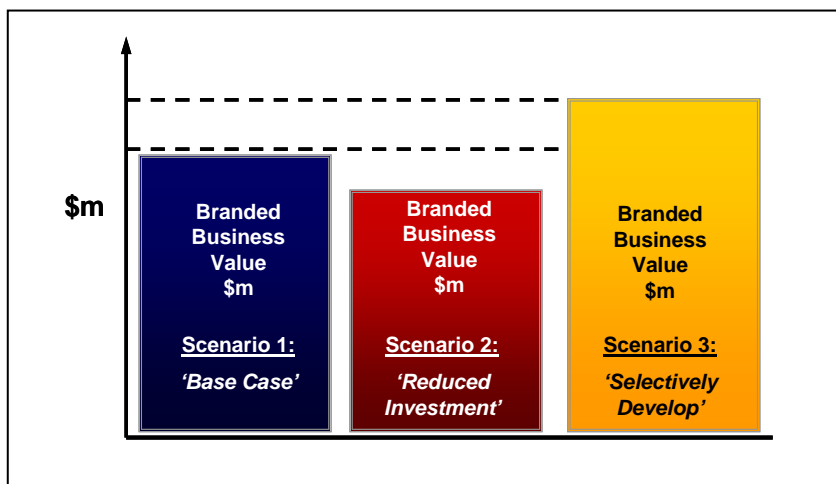
It turns out that marketers and market researchers already apply resource based thinking to brands. This is through the concept of *brand equity*, which can be regarded as a brand's stock of goodwill in the minds of customers and prospects. Unfortunately most marketing teams do not adequately link brand equity to value creation, nor do they consider its importance relative to other resources.

Once reasonable metrics are in place normal return on investment models can be applied to marketing budgets. Segmented financial forecasts should be prepared, and linked to market metrics, consumer metrics, and expected performance.

Having determined an appropriate budget, the next step is to select the best strategy. A value-based framework strips out the usual subjective arguments that accompany strategy determination. Judgement is required, but this is focused on key assumptions rather than jumping directly to the end solution. It is often unclear which strategy will yield the best result, until market and financial information are integrated. A good example is an assignment carried out for a global spirits brand. At the outset there was a belief that a harvest strategy (reduced investment) would be more effective than maintaining the status quo. A value-based evaluation was carried out and the findings submitted to the executive team. During the course of the financial brand evaluation a third scenario was identified – namely increased investment in selected markets.

It is no surprise that the 'selectively develop' option was selected. Excellent results were achieved. Despite the category being in decline, volume growth of almost 10% was achieved within a year, and the return on capital employed increased by 2%.

Diagram 2: Brand Investment Scenarios



The third key application of value-based resource management is performance tracking. An approach that covers the entire value chain is recommended. This provides insight into the links between marketing investment, consumer perceptions, consumer behaviour, market performance and value creation.

Active Financial Management of Intangible Assets

Of all intangible assets, it is only intellectual property rights (IP) that have sufficient clarity of ownership and control to be leveraged by active financial management. Licensing, structured finance, tax planning and transaction should all be part of the finance team's repertoire.

Licensing can be used to generate new earnings streams for patents, software and trademarks. Brand licensing in particular has grown significantly in the last decade. This is attractive as it extends a strong brand into new regions and categories without significant capital investment. Licensing agreements tap into the expertise and infrastructure of other entities. A well structure licensing programme not only protects the brand owner's interests, but can also strengthen the brand in its core markets.

Trademarks are suitable for structured finance purposes as they are separable and transferable rights that often have robust revenue streams. The use of trademarks as security for debt is most prevalent in private equity transactions. Some corporations enter into more complex arrangements that access international debt markets as well as achieving tax efficiencies. The resulting cost of funds saving can amount to several hundred basis points when compared to vanilla private placement debt.

Leading international groups are moving towards centralising the ownership and management of IP for operational reasons. Tax implications should be considered when

determining the most effective structure. Transfer pricing, capital gains and tax amortisation in different jurisdictions can materially affect the attractiveness of alternative options. Savvy organisations ensure that ownership (economic as well as legal) of trademarks in growth markets is located in the desired location before they gain value. Capital transfers and transfer pricing arrangements that are not robustly supported can lead to punitive disputes with tax authorities.

Portfolio management is an important facet of IP management. A bloated portfolio ties up capital and management time in under performing assets. In many instances value is added by selling, licensing or termination these assets. It is necessary to consider whether poor performance is the result of bad management or weak IP. Misjudgement can result in a hand-over of value to a shrewd purchaser. Several private equity firms in Europe specialise in reviving under performing (and under valued) brands. For instance, the Saatchi brothers (of ad agency fame) set up Saatchinvest specifically for this purpose. The corporate finance function should be on the lookout for acquisitions that enhance the value of a brand portfolio. This can result from distribution and manufacturing efficiencies or from balancing the portfolio in terms of its life cycle mix. Companies with a strong marketing team might also be able to drive greater earnings than the existing brand owner.

Conclusion

Intangible assets and other intangible resources have become the primary revenue drivers in most companies. Yet they are generally under-exploited. Clarification of the role of intangibles in the value chain facilitates better corporate strategy, and more aggressive management of intangible resources.
