The reputation and intangible asset value crash of 2008

Over the last 12 to 18 months the percentage of listed company values that can be attributed to intangibles has fallen rapidly, to stand at under 50%. Serious rebuilding work is needed

By **Nir Kossovsky**

Reputation is the impression formed by stakeholders of how a company manages its intangible assets. The median value of those assets among traded US companies has hovered around 70% for the past few years. At the end of the fourth quarter of 2008, the median value was below 50%. This article reviews market phenomena that accompanied the historic growth in intangible asset value, explores factors associated with the recent collapse in value and considers the future implications for reputation management and the world of intangible assets.

Since the end of World War II, Western economies have been decreasing their dependence upon manufacturing and increasing their reliance upon the creation and manipulation of information, knowledge and technology as the means by which companies generate profits. The resulting disposal or at least de-emphasis of physical assets and the increasing development of technology-based innovations in business processes transformed intangible assets collectively into 70% of (median) corporate value. In 2008, this decades-long trend abruptly reversed course.

Market events accompanying the rise in intangible asset value

The rise in median intangible asset value shown in Figure 2 from 20% to a maximum of about 70% of traded companies triggered a number of efforts to standardise and codify if not valuation methods, then at least public disclosure obligations about that value. The latter found their broadest expression in the US in the Sarbox legislation, the Public Company Accounting Reform and the Investor Protection Act of 2002 which was promulgated after several major accounting scandals.

Paralleling the efforts of bureaucrats and regulators, investors increasingly evolved into consumers of intangible asset financial information and created a demand for market-driven indicators of value. An early respondent was The Patent & License Exchange, which in 1999 released the first commercially available algorithmically driven indicator of intangible asset value that used current market data to reprice indicated IP value and technology sector beta (β) values daily. In 2000, the reinsurance giant Swiss Re set aside primary risk capital for previously uncovered/uncoverable intangible asset (patent title) risk. In the same year, Inspire Invest, an investment advisory, began providing investment advice based on target valuations drawn from extra-financial data. CHI Research, a valuation firm, launched an IP investment pool called the Patent Quality Select Trust in cooperation with Nike Securities, and The Patent & License Exchange released the Intangible Asset Market Index in cooperation with *The Deal*, a leading mainstream financial publication.

In 2001, investment advisers increasingly turned to extra-financial data for indicators of intangible asset value. Institutional Shareholder Services, a large investment advisory firm, launched an extra-financial data index on intangible assets and corporate governance; meanwhile, Vigeo Group, another investment advisory, began providing investment advice based on target

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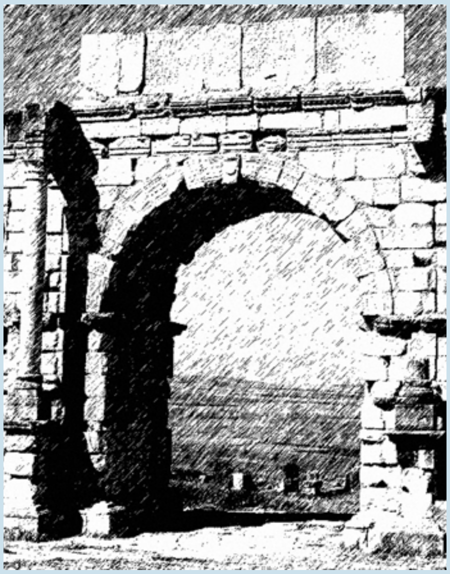
Intangible assets and brand, reputation and value



Notwithstanding ongoing efforts by the Intangible Asset Finance Society, nomenclature in the field of intangible finance is not standardised. In this article, three phrases are defined as follows:

Intangible assets. Assets with no formal home on the corporate balance sheet. Except for certain circumstances, their value is neither recorded nor reported according to Generally Accepted Accounting Principles (GAAP). They comprise the intellectual products, including patents and trademarks, that enable companies to provide goods and services; the customer promises embedded in brand; and the ability to deliver on those promises through the business processes that govern quality, safety, security, integrity, sustainability, risk management etc.

Reputation. The impression formed by stakeholders of how a company manages its intangible assets. Stakeholders comprise employees, suppliers, customers, competitors and investors. The first four cast their votes through wages, cost of goods and pricing; investors cast their votes through earnings multiples and price volatility.

Value. In the absence of an arm's-length market transaction for an asset such as a patent, trademark or business process, the value of intangible assets cannot be determined according to GAAP. There are many proprietary non-GAAP methods that provide indications of value. Financially, the values of most intangible assets are closely linked to one another like the stones in a Roman arch, so that collectively the intangible assets comprise an enterprise's reputation value – the difference between market capitalisation and book value. To continue the analogy, like a Roman arch, the loss of any one key intangible asset may destroy a disproportionate amount of reputation value.

Reputations take shape from perceptions stakeholders have about an enterprise's intangible assets. Intangible assets comprise business processes governing ethics and integrity; quality, safety, sustainability, security and innovation; patents, trademarks. Each asset supports the enterprise's value, but neglect or removal of one stone weakens – and may topple – the organisation.

valuations drawn from extra-financial data.

Intangible asset finance activity increasingly involved larger institutions. In 2005, Thomson Extel reported that 6% of buy-side brokerages were devoting material resources to extra-financial data to determine intangible asset value. PwC reported a controlled experiment showing that extra-financial data, and intangible asset value calculations arising, swayed 40% of analysts to change their target valuations of public companies. That year, Inspire Invest was retained as an investment adviser by Credit Agricole Asset Management Group.

In 2006, Thomson Extel reported that 32% of buy-side brokerages were devoting material resources to extra-financial data to determine intangible asset value, a year-on-year growth of more than 500%. Also that year, Goldman Sachs invested in, and became a distributor for, Asset4, a major provider of extra-financial data and algorithmically driven indications of intangible asset value. On the American Stock Exchange, replicating the structure of the Patent Quality Select Trust, the OT300 was created in cooperation with Ocean Tomo. Last, the sponsor of this series of articles in *IAM* magazine, the Intangible Asset Finance Society, was founded.

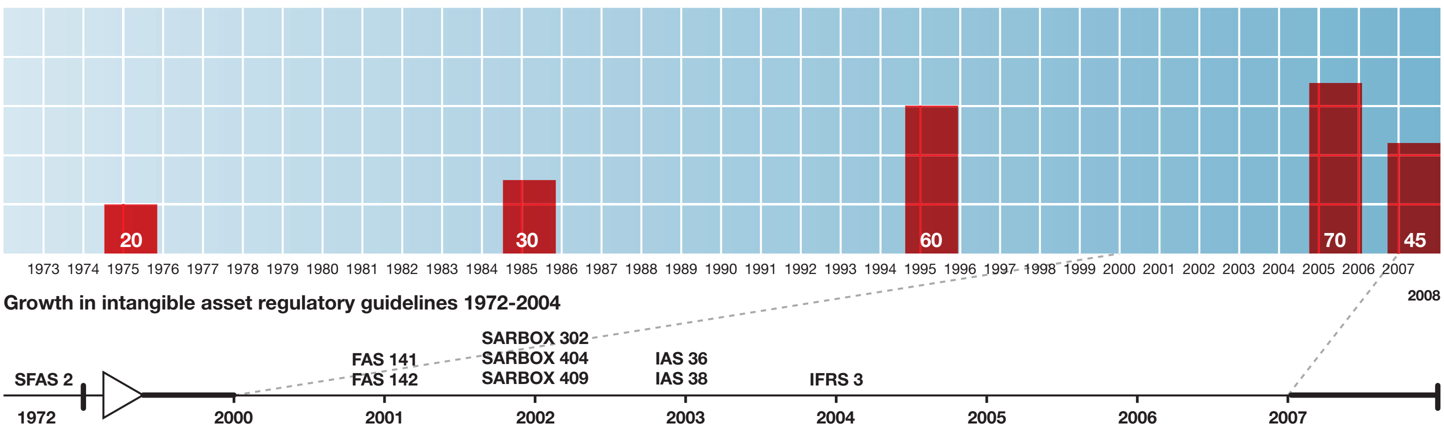
As intangible asset value neared its peak in 2007, Institutional Shareholder Services launched a new extra-financial data index on the sustainability intangible and suggested there was a correlation between its ratings and corporate value. Also that year, the Vigeo Group was retained by ABP Fund with €200 billion worth of assets under management and Munich Re set aside US$200 million in primary risk capital for previously uncovered/uncoverable risks. Last, the Enhanced Analytics Initiative, an international extra-financial investment information cooperative, reported membership had a total of US$2.4 trillion of assets under management.

The crash of 2008

As the investment community produced and consumed an increasing amount of extra-financial data, cracks began to appear in the Roman arch of intangible asset value. After peaking in June 2007, the accelerated decline became a noticeable trend by December 2007 and moved into a full collapse by mid-summer 2008 (Figure 3).

Our ongoing analysis of the tangible and intangible drivers of market value suggests that two parallel events can explain the relative decrease in intangible asset value and the concomitant relative rise in tangible asset value. Turning first to the intangible assets, the most likely proximate cause of this drop was a growing lack of confidence in their value. Confidence, a perception held by a stakeholder that is a cousin to reputation, is the friction between and among the stones in the Roman arch that hold them in place. Confidence is reflected in stock price volatility. Confidence took an acute turn for

Figure 2. **Growth in intangible assets as % of market capitalisation 1975-2008**



the worse over the summer of 2007 as evidenced by the sudden loss of stock price stability (increased volatility) (Figure 4).

Turning now to the tangible assets, a possible precipitator of loss of confidence was the slow but progressive freezing of the credit markets. This was demonstrated by the concomitant rise in the importance of cash on the balance sheet as reflected in our mean-variance models. Cash is a critical enabler when credit is unavailable. Companies with relatively more cash on their balance sheets were rewarded in enterprise value in excess of the value of the cash because investors saw evidence of superior cash management, a business process and intangible asset. Conversely, companies that had heavily leveraged themselves through mergers, acquisitions or equity repurchases and found themselves short of cash were discounted.

Reconstructing the events beginning in mid-2007, as investors collected, analysed and made decisions on the basis of extra-financial information and balance-sheet cash, favourable opinions on the reputations of the majority of traded companies were rapidly offset by unfavourable ones. Confidence waned. It was therefore only natural for reputation value to decline and cash value to rise. As the economist Alan Greenspan, Chairman of the Federal Reserve of the United States from 1987 to 2006, noted in October 2008: "In a market system based on trust, reputation has significant economic value."

Management implications for 2009

Lack of confidence in the reputation integrity of the majority of companies, exacerbated by cash shortages and frozen credit markets, appears to be the root cause of the intangible asset value crash of 2008.

The quickest path to value creation in 2009, therefore, will be reputation restoration and superior cash management.

Reputation restoration — that is, the rebuilding of confidence in the value of key intangible assets for the purpose of restoring corporate enterprise value — is a business process that requires total institutional commitment. Our risk and value forecasting models indicate that to restore corporate reputations, five general areas of activity are currently worthy of investments in time and resources.

Intangible asset awareness

Senior managers need to be aware of the primary intangible assets that support their company's reputation. If managers are not aware, then they should become aware lest they invest resources that build up assets for which they will receive no support from the market.

What might be the primary intangible assets? To generalise: in the food and drug sector, it is safety; in communications technology, it is customer-centric innovation; in retail, it is sustainability and product safety; in computer hardware, it is security; and in financial services, it is integrity. Managers should also be aware of secondary and tertiary value supporters, since they reinforce each other like the stones of a Roman arch.

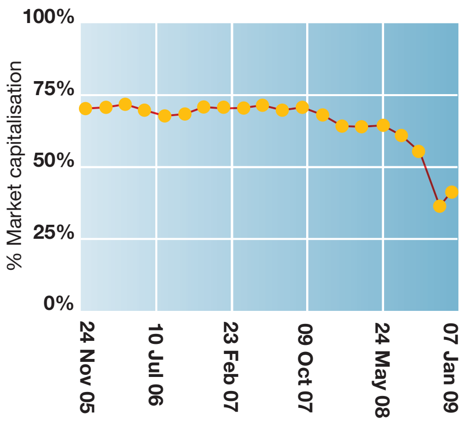
Managing to best practices

The intangible assets are business processes that link people, facilities and technology. As is the case with production engineering processes, many of these intangible assets-linked business processes can be codified and institutionalised so that they yield reliable, repeatable and reproducible outcomes.

If managers are not yet aware of best

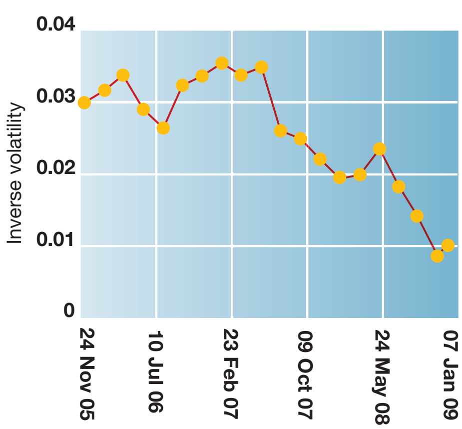
As corporate value became increasingly dominated by intangible assets in the new millennium, the accounting standards bodies and regulatory watchdogs made efforts to increase transparency through standards and disclosure guidelines

Figure 3. **Median intangible asset percentage**



The great intangible asset value crash of 2008 began mid-autumn 2007. The material inflection, however, began mid-summer 2008. Intangible asset value as a % of market cap reached its nadir in December 2008

Figure 4. **Median relative stock price stability**



Intangible asset price uncertainty. Chart of stock price stability measuring the median reciprocal of the 45-day exponentially weighted moving price average

practices, this would be a good time to rectify the discrepancy. There are a number of working committees at the Intangible Asset Finance Society dedicated to helping companies identify and, if needed, codify best practice standards.

Management requires measurement. Non-GAAP measures can be used to provide controls. At Steel City Re, we have found the Intangible Asset Financial Performance Index to be a useful metric to support management. This instrument operates at the enterprise level and signals the effects of reputation in four key stakeholder domains: customer, employee, vendor and investor. Data reported previously in *IAM* magazine shows that irrespective of business sector, companies that are superior intangible asset managers as indicated by the Index reward their shareholders with superior returns.

Monitoring and enforcing compliance

Business processes comprise numerous steps. Monitoring compliance with best practices is, of itself, a best practice. Both monitoring and enforcing are especially important in companies where the products and services depend on complex supply chains, subcontractors or other types of business network.

There are numerous technology systems that can yield non-intrusive, low-cost compliance monitoring solutions. In addition to monitoring, some of these provide both management decision support and Sarbox-related control and compliance reports. IT security is a critical feature of these systems.

There are fewer options for enforcing compliance. Insurance products could be useful and cost-effective. Other options include contractual indemnifications, penalty clauses and threats of termination.

Signalling value to the markets

Because the markets now demand a steady diet of extra-financial information, transparency into the processes being adopted and sharing non-GAAP metrics can help to restore confidence. For example, in the retail sector, one of the most frequently shared and closely watched non-GAAP metric is same-store sales.

Certain insurances can also be useful signalling instruments. One advantage of insurance instruments as tools for signalling extra-financial information is that the actuarial relationships between risk frequency, severity and premium pricing provide quantitative signals that are more accessible to financial analysts.

Signalling is at least in part a marketing function. Because the stakeholders are myriad, superior intangible asset management entails coordinates signalling to employees, customers, vendors and investors.

Superior cash management

Many companies have built equity value in their intangible assets over the years. These are iconic firms with valuable brands. They may consider this an ideal time to deploy their non-cash assets in lieu of cash payments and spend their reputation currency. Endorsements, partnerships, IP licences and beta-test participation to access innovation – to name only a few options – will allow companies to monetise their intangible assets creatively and conserve cash. And with the importance of cash being what it is today, superior cash management can only enhance their reputations.

Reputation restoration

At the end of the fourth quarter of 2008, the median value for intangible assets was below 50% of market cap after years of hovering around 70%. The data suggests that this drop was most probably triggered by a growing lack of confidence in the value of the intangible assets and the sudden rise in the value of cash. The consequence of this perfect storm is a widespread corporate reputation problem.

Reputation restoration, including superior cash management, is the most promising path for creating enterprise value for the near term. For many companies today, surviving the near term is an existential imperative. *iam*

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