# Intangibles crucial to M&A success, report claims

**In this series, some of the *IAM* blog's most popular posts are reproduced in the Insight section of *IAM* magazine, along with the responses that they generated. Note that both the original blog and the responses are edited to conform with *IAM* house style. Not all responses are necessarily reproduced.**

**Here we run a blog originally posted on 13th April that looked at a report which claims intangibles are significantly under-valued and under-appreciated in M&A transactions.**

Here's something I should have picked up on earlier: *The Silver Bullet of Success: Winners and Losers in the M&A Game**. It was published in February by the Hay Group, the global consultancy company. What is interesting about the paper is its focus on intangibles. On the front cover it claims: "For those that dare to pull the trigger; the rewards of M&A remain as high as ever. But unless 'intangible capital' gets the senior executive attention it deserves, value will remain untapped and could even be destroyed."

The paper is based on interviews conducted with "560 senior management level executives with experience of M&A transactions worth at least $500m over the past three years". Its main findings are that:

- Companies underestimate intangible capital.
- Buyers risk damaging deal value because of this.
- Management of intangible capital influences integration success.
- Poor management of intangible capital has major consequences.
- Dealing with intangible capital is considered to be more challenging in cross-border transactions.
- Two-thirds of respondents (66%) believe that an increased focus on intangible capital would improve merger success.
- Most business leaders (61%) plan to increase their focus on intangibles, but need guidance on how to capture data about intangible capital during M&As.

Although *The Silver Bullet of Success* does state that acquirers tend to undervalue the value of target company intangibles by a significant amount, it is more concerned with the post-acquisition phase. It says that if an acquirer buys a company without understanding its intangibles – and clearly, not valuing them sufficiently in the first place is symptomatic of this – then it is creating a whole heap of potential trouble. After all, if you do not understand what it is you are buying, then how on earth are you going to be able to leverage it and/or integrate it into your existing corporate structures? And if you cannot do that effectively, the acquisition is not going to bring the benefits it could have done.

The paper is written from the perspective of the buyer, but it seems to me there are some important lessons for target companies too. Notably, if you focus on intangibles you are going to be in a much better position to drive up the value of the deal or, if things are hostile, to fend off unwanted attention. Obviously, it's down to shareholders to agree or disagree, so keeping them in the loop about intangible values could well pay dividends – if they understand them, they are less likely to vote through an M&A if such values are not reflected in the deal price.

Another thing that caught my eye is that the Hay Group seems deliberately to exclude patents from its extensive list of what intangible capital includes. It does list "Willingness to innovate" and "Unpatented intellectual property", but of patents themselves there is no mention. The paper provides no justification for this, but it does strike me as odd that trademarks, copyrights, trade secrets and the like are considered intangible capital, but patents aren't. I wonder why that is. Of course, it could be that there is no reason. In which case, the Hay Group itself is surely missing an important trick. ■

**http://www.mergermarket.com/The_Silver_Bullet_of_Success_Jan_2010.pdf*

To access the *IAM* blog, please visit: **www.iam-blog.com**

## Comments re: Intangibles crucial to M&A success, report claims

I think they've re-cast the definition of intangibles by their use of the term. The way I read the report is that, for the purpose of the report, patents are tangibles. That is, they are things that can be identified and listed in an appendix and objectively understood as to their contents, whereas the report kind of deals with the need to manage aspects that are harder to classify, report on and so forth, like 'customer relationships' that make the company hum. For example, I'm not sure how one would properly identify a customer relationship, with its vast human complexities, and list it in an appendix. Patents, however, can be so identified and listed, so in this sense are tangible.

Unpatented IP in this context would, I think, then refer to that whole set of stuff being developed and representing actual value, due to it at the time of assessment being somewhat slippery to put your finger on, that would not show up in a list anywhere and would require a different identification procedure, such as personal interviews.

The idea of valuing things is one thing; identifying things that could be valued is another problem. The taxonomy here is underdeveloped so the identification of value carriers and their interrelationships is underdeveloped. And of course, one can't really objectively accord an objective value to something one can't objectively identify. So either you don't try or you make use of your gut to process all of that.

**Matthew D Powell**, Sim & McBurney/Sim Lowman Ashton & McKay LLP

Delighted to see the high level of interesting comment and debate caused by Hay Group's recent report on M&A success factors.

Most advisers will be aware of the long-running accounting debate over how to value assets such as IP. Hay Group's perspective on deal value does not address this well-established category of balance-sheet asset, because there are now accepted standards for measuring these. As Matt points out, we focus only on those aspects of the deal that are hard to classify and as such, an issue that is under-addressed in the market. Seventy per cent of executives who participated in our European survey stated that tackling intangibles is just "too difficult" and our research has proven that it is a key factor in successful integration.

# The best of the blog

What's a good dealmaker to do? Advice from those at the coalface who have been successful suggests that executives need to:

- Start looking at intangible capital much earlier on in the deal process.
- Get their leadership team in place much more quickly.
- Have a clear approach to dealing with the four key barriers that will hinder integration if not formally addressed – culture, leadership, customer bases and corporate governance.

**Claire Elliott**, Hay Group, Paris

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I see the Hay Group study as an important companion to a study of 700+ 2007 M&A transactions by Ernst & Young called *Acquisition Accounting: What's Next for You*?

The E&Y study is valuable because it is a broad sample and has a lot of hard numbers about booked intangibles (mergers are one of the rare times that intangibles make their way onto the balance sheet). The overall average for the deals examined was 70% intangible. This broke down to 23% identified intangibles (the most common ones were brands, customer contracts and technology) and a whopping 47% as goodwill.

What's interesting is that the Hay Group study cites managers' estimates that most deals are 30% intangible. I take this to mean that their understanding of intangibles is coloured by the amount that accountants recognise, not by what is really happening.

And the business world continues to move forward with a gigantic information gap. We in the intangibles community have to make it our business to help companies fill in this gap.

**Mary Adams**, Intellectual Capital Advisors

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Well done for tracking this report down. We keep a good eye out for reports from the mainstream of business that show a shift towards intangibles getting more attention in M&A and funding (and indeed in any businesss transaction or event). Mary, as ever, is on the money in questioning what the 40%+ goodwill figures (the balancing amount after everything else) really are. It should be possible with intelligent classification to allocate all of the price paid, surely.

I was at a CPA dinner recently and one of the senior M&A team at EY London was also stressing that IP was becoming an increasing factor in M&A, and was expected to increase further into the next M&A wave.

Mary is also on the button in stressing our responsibility to bridge the gap. As ever, I start by questioning the terminology and language. With intangible capital, we have probably the tenth different variant of terminology I've seen in 2010 alone, and I'm like Joff in questioning why patents could be called anything but an intangible asset – again, folks, we need a common language. If we can't even speak IP in the same way, how on earth do we communicate with each other, never mind the outside business world?

**Andrew Watson**, ipVA

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The problem here is not in splitting hairs over terminology. Instead, it is inherent in how a deal price is determined. To put it in very simple terms, a typical M&A deal is negotiated at the stock price level for the entire company, without really giving any pricing consideration to any particular asset, tangible or intangible.

I would argue that it is very naive to assume that the buyer's management does not understand the value of IP – on the contrary, that is mostly the reason why they even look at the target in the first place. However, the pricing equation works as such that the deal price is determined by the stock (equity) price of the target and is often a reflection of who is a better negotiator, buyer or seller, how many other buyers/sellers are involved; what the board agreed to pay; the tax structure of the deal, etc ... it is very seldom the case that when you start adding up the separate assets (minus the liabilities) that compose a company, you will end up with anything that is even close to the acquisition price. That is why the purchase price allocation done after the deal by the buyer (the seller doesn't care, really) for accounting purposes of booking the new assets ends up with a residual, which is allocated to goodwill.

**Efrat Kasznik**, Foresight Valuation Group LLC

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Now that insight from Efrat Kasznik is very interesting to me. So, Efrat, I think what you're saying is that typically at no point during an M&A negotiation is a patent parsed out for discrete pricing between the parties. The discrete information is not typically across the table as a talking point.

It would be useful for me to know how a buyer actually sits there with the list of patents to understand them. Is it enough for a buyer to make sure the patents represent a fairly complete record of the target's history of R&D activity, and is it typical for buyers not to bother doing backflips to determine patents' discrete prices?

To this end, would it help companies that are struggling to convince C-level execs to devote more resources to patenting to show those execs that, with each patent, a chapter in their R&D story is being very powerfully documented?

**Matthew D Powell**, Sim & McBurney/Sim Lowman Ashton & McKay LLP

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Matthew – these are good questions, and I will try to address them below. Let me start with your second question. Having a good patenting strategy in place is always a good idea, regardless of whether you plan to become an acquisition target. It provides many competitive and strategic advantages, and helps you protect your innovation.

Having said that, you should not expect that the pricing of your company as an acquisition target in an M&A deal will be driven by your IP portfolio. The scenario I was trying to portray, which I believe is a realistic one, is that pricing is done for the overall company as one bundle. Pricing negotiations usually start from the point of an offer made by the buyer for the entire company (= stock price), based on a discounted cash flow (DCF) model prepared by the buyer, supported by market comps. The buyer usually creates two DCF scenarios: (1) for the target as a standalone entity; and (2) for the target as part of the buyer's organisation, with all the synergies that come with that. The difference between the two scenarios is the premium that the buyer is willing to pay; and the negotiations usually revolve around the assumptions that go into each scenario and how much of the synergy the buyer is willing to pay for upfront (which determines the final acquisition price).

In that environment, the IP portfolio will not be priced separately, on a standalone basis or any other basis, as part of the pricing negotiations. There is a period of due diligence during which either side can walk away from the deal – that is when the IP portfolio will usually be examined, and it can certainly be a reason for walking away from the deal if major problems are discovered at that time. In that regard, the IP portfolio is part of the risk factors associated with the deal, and not a pricing component of the deal.

**Efrat Kasznik**, Foresight Valuation Group LLC