How Intangible Assets Drive Capitalization

BY WESTON ANSON*

Old relationship between earning per share and stock price no longer key to market capitalization; now it's intangible assets, IP

The old relationship between earnings per share and stock price is no longer the primary factor driving market capitalization of most companies. Instead, the new paradigm or basis of value is the value of a company's intangible assets and intellectual capital. Trademarks, patents, brand names, copyrights, software and other intangibles comprise the primary bundle of underlying value for most emerging U.S. companies, as well as for many of our mature companies. This is why traditional relationships between earnings per share and stock price are no longer valid. Instead, the most important relationship is that between the value of a company's intangible assets and its overall market capitalization. In this article, we focus on that relationship.

Today's savvy CEO focuses very carefully on the relationship between the market value of his or her company and the value of the intangible assets embedded in every share of stock. One has to look no further than IBM to understand not only the importance of the concept, but the reason why astute CEOs focus on increasing value from intangible assets. In 1997-1998, IBM earned between $6 million and $8 million dollars in revenues from their intangible assets, primarily in the form of royalties and user fees. Louis Gerstner, CEO of IBM, clearly stated that he intends to triple that figure in the next two years. Why? Because the return from intangible assets is superb and it rapidly drives stock value as well as earnings per share.

One has to look no further than the current feeding frenzy in Internet and e-commerce stocks to understand that intangible assets and intellectual capital are driving the value of companies like Broadcast.com, E-Bay, E-Trade, Infoseek, INTUIT, YAHOO, AOL, Amazon, etc.

HIGH DEGREE OF INTANGIBLE VALUE

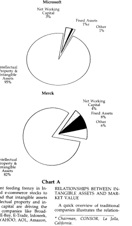

Chart A

RELATIONSHIPS BETWEEN INTANGIBLE ASSETS AND MARKET VALUE

A quick overview of traditional companies illustrates the relation-

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ship of intangible assets to market value. We will look at the total market value of several companies: Microsoft, Merck, Proctor & Gamble, Amazon.com, as well as Arch Coal, and Tyson Chicken. Before doing so, however, a few more words on the Internet and electronic commerce stock prices in today's market. The cry on the street appears to be, "There is no underlying value, why are these prices so high?" Our reply at CONSOR is that typical investors realize that important assets are not bricks and mortar or conveyor belts and lathes, nor are they necessarily trailer trucks and air-conditioning systems. Rather, true value in our newly energizing, industrialized companies is found in the form of intangible assets. And the relationship between the value of intangible assets and stock price and market value is the key relationship that CEOs need to focus on.

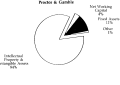
Chart A provides a snapshot of two companies in which there is a very high degree of intangible asset value. These are both companies that are well established and are recognized for their operational efficiencies as well as for their tangible asset management — Microsoft and Merck.[1]

You will note that in the case of Microsoft, the value of the intangible assets and intellectual property is 95%, and for Merck it is 82% of the total capitalization. Yet no one would accuse the per-share price of Microsoft or Merck to be out of line, given today's values for industrial companies. Here are two established, profitable, well-managed companies in which the intangible assets are in the range of 90% of total market capitalization and asset value.

Chart B shows two other companies that we believe are useful to analyze because of their use of intangible assets — and because of the way those intangible assets obviously drive the value of the stock price in the marketplace. The first is Proctor & Gamble, a company

1. The author wishes to thank Russell Parr and his associates at AUS Consultants for their input into Exhibits A and B; as well as a heartfelt thanks to Mr. Parr for his help and friendship over the last many years.

HIGH DEGREE OF INTANGIBLE VALUE



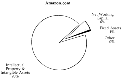


Chart B

with whom CONSOR has worked consistently over the last eight years on valuing, licensing, and extending intangible assets, including brands, trademarks and patents. It's interesting to note that the total value of intangible assets at Proctor & Gamble approaches the 84% range. And yet for years it has been viewed traditionally and currently as a solid, extremely well managed, consumer-goods company based in the bedrock of American industry.

Amazon.com, the other company on Chart B, is a newly energizing internet stock that is seen as overly independent on its intangible value — yet, at 93% of market capitalization, its proportion of intangible assets as a percentage of market capitalization is within range of Microsoft, Mercks, and even Proctor & Gamble. Amazon.com's intangible asset proportion is also in the 90% range, not unlike Microsoft or Proctor & Gamble. The difference is that with Amazon.com, virtually all of its assets are intangible. While there are conveyor belts and some rented bricks and mortar, as well as inventory, the essence of this company is intangible assets. And its stock price continues to be driven very rapidly upward.

Finally, let's look at a company with relatively low degree of intangible asset value, Arch Coal. It's a commodity business with a commodity product and the vast majority of its asset base is in fixed and semi-fixed assets. The total value of its intangibles is roughly 25% of the total capitalization. Arch Coal is as good an example as one can find of a solid, tangible asset-based business, in an established industry, driven by tangible rather than intangible assets. Its stock price reflects the fact that investors recognize this key element of Arch Coal.

LOW DEGREE OF INTANGIBLE VALUE

Arch Coal

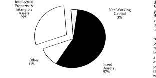


Chart C

WHY INTELLECTUAL AND INTANGIBLE ASSETS HAVE GROWN IN IMPORTANCE

So, what do we conclude from the five examples above? What are the reasons intangible assets are increasingly important? And what are some of the underlying trends driving the importance of intellectual and intangible assets? Most of the reasons are obvious, some less so:

- Increasing globalization of the business community.
- A need to maximize return from all assets, not just tangible assets.
- Expanded global marketing.
- Expanding global use of intellectual property such as trademarks, brands, and patents.
- Increasingly competitive corporate environment.
- A rising tide of product parity in quality, appearance, or function, so that an intangible asset can differentiate a product.
- In many countries, such as Japan and Germany, stagnant returns on fixed and tangible assets.
- A growing awareness that protection of these increasingly valuable assets is important.

What are some of the other causal factors for why intangible assets and intellectual property represent so much value? One can be found in what is known as Tobins Q, which states that market value of assets and the replacement cost of assets are critical factors, and the highest market value and highest market valuations tend to go to those companies that have a competitive advantage in the form of assets that are difficult to reproduce. In other words, the competitive advantage represented by brand, image, know-how and technology reap the highest reward in the marketplace.

Our own proprietary techniques at CONSOR tell us the same thing. The Brand Value Equation (BVEq[SM]) shows us that intangible assets tend to generate the greatest cash flows and the greatest market values relative to investment. In addition, our VALMATRIX® and VALCALC[SM] approaches to company valuations are able to identify those companies in which market values will be driven particularly by intangible assets to any appropriate level.

Finally, there is the issue of reproducible assets versus competitive advantage. This means that tangible assets can be reproduced by competitors — anyone can build a toothpaste factory or an automobile factory or dig a gravel pit. However, brands and other intangible assets are the specialized resources and knowledge, that permit a company to earn cash flows and therefore, market capitalizations well in excess of other companies with similar amounts of intangible assets.

Do different industries have different levels of need for intangible assets? Absolutely. However, can a commodity-based company afford to neglect its tangible asset strategy?

% OF TOTAL MARKET CAPITALIZATION

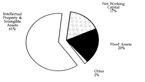


Chart D

Absolutely not. It's the intangible asset/intellectual property/intellectual capital base that matters in market value today.

A final brief example of a company able to take a pure commodity product, and cleverly use all of its intangibles to increase value, is Tyson Chicken. Chart D is rather remarkable, it shows that over 60% of the market value of Tyson rests in its intangibles — and yet, they are in the ultimate commodity business: dead chickens.