



Investment on intangible assests

Investment on intangible assets: the way to increase the value for S&M size companies

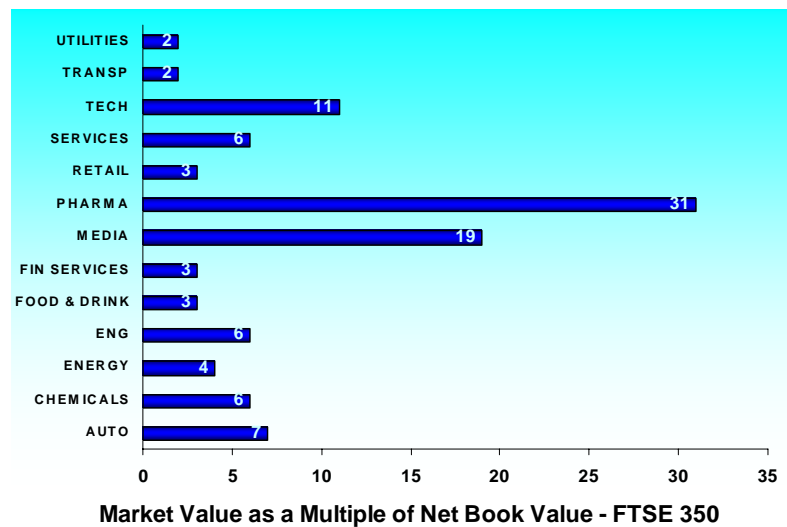
The time has arrived for small and medium size companies to rethink the way they allocate their budgets

Let's assume that you are considering selling your business. Over the course of more than a decade, you have spent part of your budget in making well-know the business's name and logo within the local community. Is this community awareness taken into consideration when pricing the Market Value of your business? It this investment in marketing helping you to get that premium price you want?

It is not necessary to reach the point of selling or getting new investors for the company to ask these kind of questions. In fact, this is a common situation facing owners and CEOs of companies willing to get the best long term returns of their businesses. Each time managers make decisions, such as buying software, sending employees for training, hiring a consultant or start an advertising campaign, they should look at the way these actions increase the total future value of their businesses.

What does drive the value of a company?

It is undeniable that value of any object lies on the eyes of the buyer. He is the one who decides if the object is worth its price or not. In the case of business, the valuation of a company is a very complex process. The stock market is perhaps the best place to see how objective and subjective elements dynamically shape the final price and define the ultimate value of the companies.



Consider this: nearly 60 percent of the aggregate value of the US stock market is based on investor "expectations of future growth". On May 2003, there was an extraordinary \$7.6 trillion closely linked to future value — an amount that represents 58% of the aggregate value of the US stock market. And this is not just a US phenomenon: a joint Financial Times/Stern Stewart & Company study of the UK stock market in September 2000 showed £864 billion of equity value linked at future expectations among just the largest 200 listed companies¹.

Today value of a company is based on its capability for tomorrow growth. Interestingly, the companies showing the biggest market value are those that are building themselves on intangible assets. In fact, during the past 25 years, intangible assets have supplanted tangible assets as the key value drivers in the economy in developed countries. In 1978 book value, as presented in the balance sheet of companies and mainly dominated by tangible assets², was on average around 95% of the market value of companies in the US. Fifteen years later, book

¹ Accenture - Outlook 2004, Number 1 37. Value measured by the Russell 3000 Index.

² It is mandatory for all publicly quoted companies in Europe from 2005 to reported goodwill to an impairment test for fair market valuation once a year

value was just 38% of market value³. The importance of intangible assets, the immaterial value of companies such as relationships with business partners, brand awareness, the ability to innovate, the ability to multiply knowledge within the organization, will greatly increase in the next decades.

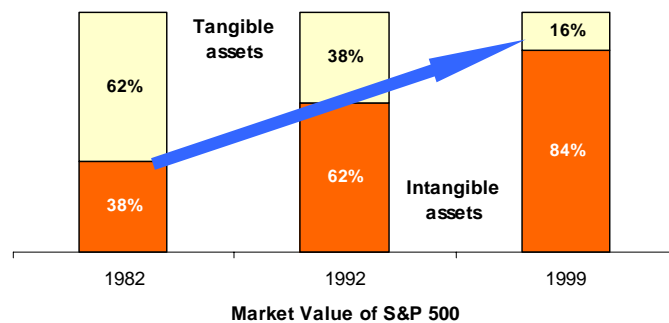
This global movement toward intangible assets creation must be a wake-up call for managers and CEOs of small and medium size companies, who still show a clear preference to “purchase” tangible assets rather than “develop” intangible assets. The result is that more and more resources are put into the **operation of the business** (such as producing, selling and delivering products and services) rather than on the **preparation for future growth** (for instance in research and development, brand building, establishing good customer relationships, employee education, flexible supply chain networks or information technology infrastructure).

This behavior is rooted on the traditional corporate reporting and enterprise management practice of S&M size companies, which are too much focused and limited to the short-term financial perspective. Most managers still consider important only those investments which

have a direct impact on profits and revenues. Because managers can not see their link to short term financial gain, intangible assets are considered of low importance and therefore of low investment priority in their budgets.

human capital and keep the good employees.

In order to do so, companies must constantly optimize their entire bundle of “intangibles and tangible assets” in order to create sustainable value for customers,



But, are Intangible Assets really important?

Many S&M size companies are only competing mainly from the seller’s point of view, that is, they focus on produce, distribute and sell products. Increase productivity and exports is important for the majority of S&MS enterprises. However, nowadays companies require to compete as well from the buyer’s point of view. To be successful and remain so, they must know buyers’ needs to bring new products onto the market through a systematic long-term workable and profitable relationships with customers and business partners. They must, therefore, constantly develop the company’s

shareholders. A research conducted in 2003 indicated that in the late 1990s the annual U.S. investment in intangible assets (R&D, business processes and software, brand enhancement, employee training, etc.) was roughly \$1.0 trillion, **almost equal** to the total investment of the manufacturing sector in physical assets: \$1.2 trillion (what is the proportion of spending on intangibles versus tangible assets in your organization?). This change toward intangible investment requires a holistic view of the entire value creation system of a company, an approach that consider as key decision criteria the increase of economic value through the intelligent combination of its various value creating processes, its competencies, resources and assets.

³ Juergen Daum , “The new New Economy Analyst Report” July 26, 2001.

⁴ Nakamura. Oxford University Press, 2003, pp. 19-47

Some managers of S&M size companies argue that, although they are necessary, intangible investments only have an indirect affect on the financial performance of a company. That is not totally true. Intangible investments, not only have direct link to, but also bring in returns that are significantly higher than costs of capital and the returns of fixed asset investments. The key is to look at their effects from a more long term perspective.

For example, a study conducted at the New York University showed that Research & Development investments of 83 companies over a span of 25 years returned 17%, whereas capital spending earned just the cost of capital of 8%⁵. Another study on IT investment involving 1031 firms over a period of 8 years showed that each dollar of IT capital is associated with 5\$ to 20\$ increase on market valuation, whereas each dollar of installed property, plant and equipment is valued at about the same one dollar and a dollar of other assets, which includes accounts receivable, inventories and liquid assets, is valued at about \$0.7⁶.

OK, let's accept that we need to invest more in intangible assets. How do we prioritize and select the projects that most increase our intangible assets? How

do we allocate the budget to maximize the company's potential future value?

The link between Intangible assets, organization and Strategy

Intangible assets don't create value by themselves, so they're not easily tradable or salable to others. Their value comes only in the context of the organization and has to be linked to organizational strategy and to all the other intangible and tangible assets the organization has. Otherwise the value of intangibles dissipates much quicker than that of physical assets. Let see this through some examples:

□ Amazon.com was able to expand from books to music by leveraging its **customer base** that it acquired through expensive advertisement campaigns. Its success was based on offering punctual delivery and with good customer service through an **efficient supply chain network** and **highly trained and motivated employees**.

□ Would you save your money in Monoprix in stead of a bank? English people do that. Tesco, the UK's largest supermarket chain succeeded in offering financial services to its clients. This extension from retailing to financial sector was

possible thanks to its intangible assets such as **brands and customer relationships**.

□ How much money can you make with a \$10 Million revenue company?. In 1995 Cisco, the world largest producer of network products bought Crescendo, a company with annual sales of \$10 million, for a purchase price of \$97 million. A year later Cisco made more than \$500 million in sales of Crescendo products by combining its **technology** with Cisco's own **customer base and sales network**.

These examples show a clear synergy between intangible assets, organization and strategy. The combination of these three elements into one single vision, although it seems to be logic, does not exist in most S&M size organizations. In fact, still some companies can not even predict the consequences of their actions beyond the first sequence of activities.

This situation is due in part to the lack of processes and tools which would allow managers to have a better understanding of the steps through which these three elements are combined in the value creation process. However, these tools exist and are very well in use by big, leading

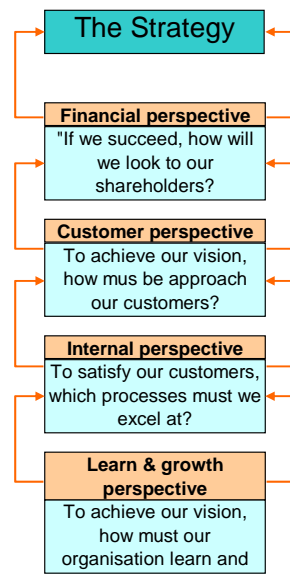
⁵ Baruch Lev, Professor of Accounting and Finance - Stern School of Business at New York University

⁶ *How the Interaction of IT Affects Stock Market Valuations*, Erik Brynjolfsson, MIT 1999.

⁷ Interview with David P. Norton: "Intangible Assets and the Balanced Scorecard", July 18, 2001

organizations. For example, how to link training with sales. If a manufacturing company send a group of employees from the production line to a training program for a month, it should expect that something like quality will improve, and if quality will improve, then customer confidence on the products will improve, and if customer confidence improves, then they will buy more products⁷.

This “if-then” relationship provides a perfect way to draw the relations between activities and their outcomes. The result is the well-know “Strategy Map”, a graphic representation of the links between assets, organization and strategic objectives. This process put together **learning & growth activities, business process, customer benefits and financial performance** under one single framework, the well know Balanced Scorecard. The implementation of Strategy Maps forces an organization to clarify the logic of how it intends to create value and for whom.



Strategy Maps:
A simple model of Value Creation

So, what is next?

Frameworks like the “Strategy Map” – Balanced Scorecard can help S&M size companies to prepare their organization for future growth. The big challenge managers face is the change from a short-term money-driven view to a long-term value-driven approach to business. Executives that are interested to evaluate more appropriately the performance of their business units and to better understand the future performance of their enterprise as a whole, should pay more attention to the value creation process of their company and in particular to its major driver: the development of Intangible Assets.

⁸ R. Kaplan, D. Norton, *The Strategy-focused Organization*, Harvard Business School Press 2001



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